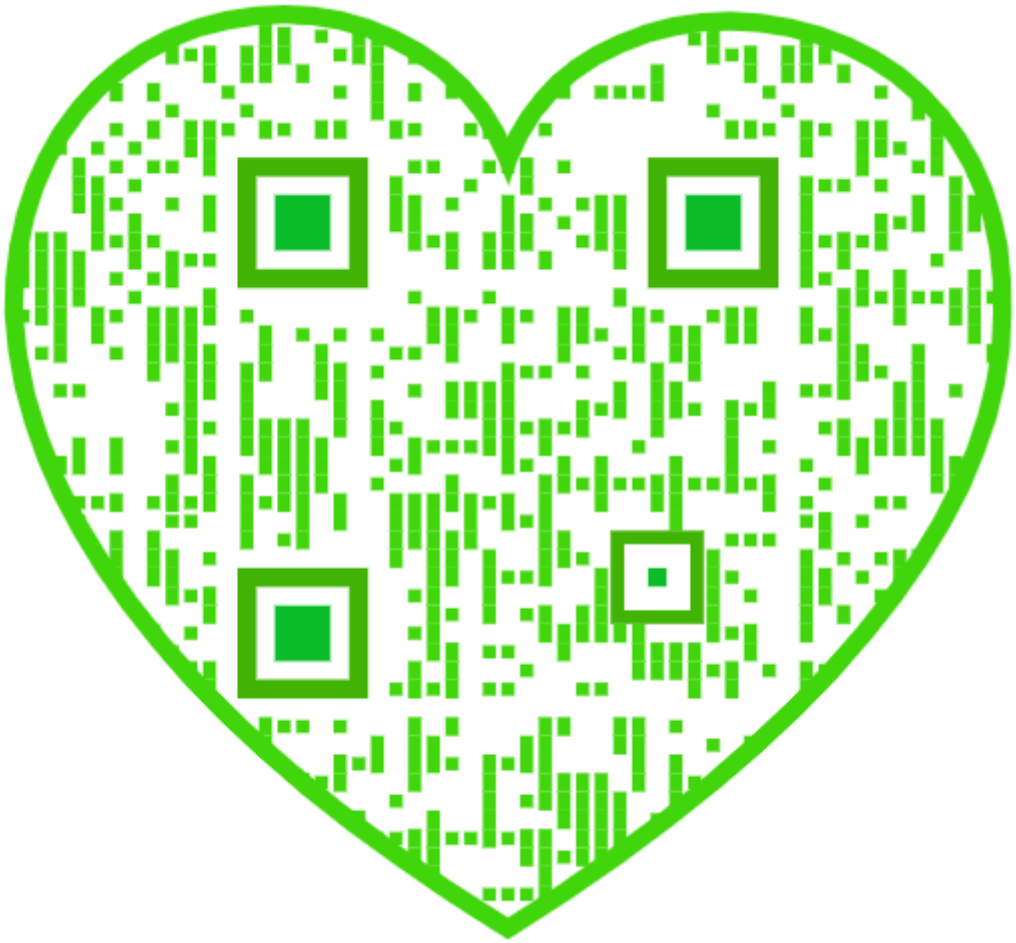

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BUSINESS ACCOUNTING

HAROLD DUDLEY GREELEY, C.P.A., *Editor*

Volume I—Theory of Accounts
By Harold Dudley Greeley

II—Constructive Accounting
By George E. Bennett

III—Cost Accounting
By DeWitt Carl Eggleston

IV—Advanced and Analytical Accounting
By Henry C. Cox

V—Illustrative Accounting Problems
By Charles F. Rittenhouse and Harold Dudley Greeley

Business Accounting

VOLUME I

THEORY OF ACCOUNTS

By

HAROLD DUDLEY GREELEY, LL.B.

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EDITORIAL PREFACE

Ten years ago almost any contribution to the literature of accountancy would have been welcomed. Today, however, with the increasing number of excellent publications, it is incumbent upon one who puts forth a new accounting work to justify his action. Much more is it necessary to explain the publication of a set of accounting books. Hence it is desirable to state at the outset the purpose of "Business Accounting" and to outline its scope and general methods of presentation.

While many books have been published on accounting topics, in almost every case they are unrelated volumes. In some few instances, a volume on accounting has logically followed another by the same author, but with these few exceptions every one published has been written without connection with, or adjustment to, any of those already existing. Under these conditions, the student of accounting, to get any connected and logical knowledge of his subject, must find one of his books here, another there, a third somewhere else, and bridge over the gaps between them as best he may. The process is difficult, and the accounting knowledge he obtains is not always well co-ordinated and logically developed.

The volumes of "Business Accounting" are intended to meet this situation. They cannot, it is true, provide a course of study in the sense that prescribed readings are recommended, written answers to questions required, and personal instruction given. Neither do they con-

stitute an encyclopaedia of unconnected and isolated articles. Rather are they an attempt to present in simple, non-technical language the basic principles of account-keeping and their application to various lines of business, together with general directions for preparing, analyzing, and interpreting accounting statements.

One who starts at the beginning of Volume I and works faithfully through to the end of Volume IV, and then solves the problems and examines the solutions of Volume V, should acquire some real understanding of the theory and practice of accounts—a knowledge that, supplemented by experience, should enable him successfully to stand the test of practical work in any ordinary business office and furnish a foundation for going as much further into the study of accountancy as he may desire.

It may be noted in passing that the volumes of "Business Accounting" have been indexed in such a way as to provide many of the features of an encyclopaedia, so that the person desiring the practice on a particular point or accounting ideas of suggestive value in particular lines of industry will be able to use the set to advantage.

Taking up the volumes of the set in order—Volume I presents the fundamental principles of account-keeping and statement preparation. Upon these basic principles all systems of account are built. Volume II explains the principles governing the development of the simple accounting procedures described in Volume I to meet the needs of more complicated and more extensive systems of financial accounting. Volume III explains in much the same way how the basic principles

have been applied to factory or cost accounting. Having thus traced the fundamental principles into more elaborate financial and cost accounting procedures, Volume IV treats accounting principles and practices which are more advanced than the basic ones described in Volume I. These advanced principles are in most cases subject to differences of opinion, as to their nature or application, among persons qualified to deal with them, and it is for this reason that their discussion is confined to Volume IV. Supplementing the illustrations of accounting principles and statement preparation, there follows in Volume IV a practical discussion of the methods of verifying accounts and statements and of their interpretation and analysis.

The set closes with Volume V, which gives a number of problems of a practical nature, together with their solutions. The working of these problems will not only clarify the reader's ideas but in many cases will provide models upon which he can base accounting procedures and build statements to meet concrete situations arising in his own work.

The readers to whom this set will appeal most strongly may be divided roughly into two classes. There will be, on the one hand, business and professional men, bankers, office managers, and other executives who feel the need of understanding in a general way the methods of modern account-keeping and statement preparation. There can hardly be excuse nowadays for them to consider bookkeeping methods and accounting statements as too complicated to understand or of such slight importance as to merit no attention. They need a grasp of the subject so that they may judge for themselves

whether bookkeepers and other persons who keep accounts for them and render statements to them are giving information which is accurate, adequate, and presented in the most intelligible form. The entire tendency of modern business and civic life is toward more exact accounting, of which the accounting requirements of the present income tax legislation are but one indication. Any person having substantial interests at stake should be able to appraise intelligently the stewardship of those to whom his interests are intrusted and the volumes of "Business Accounting" will give him the technical information this demands.

The other class of persons to whom "Business Accounting" will appeal is composed of those whose duty it is to keep accounts and to prepare statements. They should find in this set an inspiration and an aid to more intensive study, which in turn will result in improved accounting ability and an enhanced wage. The careful and intelligent use of these books will lead beyond question to increased power of service to employer and community.

HAROLD DUDLEY GREELEY,
Editor, Business Accounting Set.

New York City,
April 1, 1920

PREFACE

As stated in the editorial preface to "Business Accounting," the underlying purpose of this first volume is to explain, in readable form, the fundamental principles upon which all account-keeping and statement preparation are based—to give a clear and logical presentation of accounting theory and practice which, while not intended to go into the refinement required by the expert, will nevertheless give an understanding of the technique of account-keeping sufficient for all ordinary business purposes.

The present volume purposely covers the field of accounting theory in a broad rather than an intensive way. It suggests many problems which it does not solve but which are discussed and explained in succeeding volumes. It gives simple descriptions of all the fundamental bookkeeping and accounting procedures and explains the theory underlying the usual practices. Throughout the book there are questions and practical examples, including a few sets of business transactions, to enable the reader to apply the theory as his understanding of it develops.

As this book covers a comparatively unoccupied field, namely, that lying between the bookkeeping of the business college and the accounting of the professional school, it cannot be expected that the method of presentation will meet with universal approval. The

author, however, particularly desires that readers will bear in mind what he is trying to accomplish, and give him the benefit of criticisms and suggestions so that succeeding editions may benefit thereby.

The table of contents indicates, better than a preface could explain, the scope of the volume, an attempt to explain unquestioned principles and methods of accounting procedure in a non-technical way which will be of value to the readers for whom it is intended.

HAROLD DUDLEY GREELEY

New York City,
April 1, 1920

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Theory of Accounts

Part I
Fundamental Principles

CHAPTER I

MODERN ACCOUNTANCY

1. The New Accountancy

One of the most striking developments of business organization today is the way in which methods of record and control have kept pace with, and in fact made possible, the steady increase in size, volume, and complexity of business operations. This has been due to the modernization of accounting methods by which all business transactions are fully and accurately recorded and their results interpreted. Accordingly as business increases in volume and complexity, new and more difficult problems of finance and management arise, accounting takes a higher and more important position, and the need for a better knowledge of the subject on the part of business men as well as accountants is more clearly and more generally recognized.

Owners and executives now look to accounting records to give them prompt and accurate information and guidance on matters which a few decades ago were left to conjecture, but which today are closely watched and controlled. As a result of this the demands made upon the art and skill of the accountant in reducing masses of data to orderly systems of record and control are steadily increasing, and there has come about a remarkable development of accounting methods and practice.

The old accounting was good as far as it went and

has become incorporated in the new. The final goal of all accounting—the profit and loss account and the balance sheet — is substantially the same as it always was; but the fact is generally recognized that the simpler accounting methods of early days are quite inadequate under present-day conditions. Modern accounting, as intimated, does much more than merely record financial facts for the purpose of showing final results on the balance sheet. It aims to insure a complete and accurate report of business activities day by day, to detect error, to make fraud difficult, to save labor—clerical and other—to trace wastes and compare efficiencies, and to summarize results in such a way that the most profitable course in the future is as clearly indicated as are the errors which have caused losses in the past. Modern accounting methods have thus become, to an extent not realized by those who have not followed their recent developments, an essential part of the mechanism of every highly organized and efficient business enterprise. The financial worth of a business may be clearly read from its balance sheet and profit and loss statements. Comparative statements and supporting schedules will show as clearly where it has been gaining or losing and its general trend. To the accountant or to the business man with some knowledge of accounting, such facts are easily gained from the accounting records and are invaluable as a basis for judgment and action. To the many business men, however, who know little or nothing of accounting, these same records are almost meaningless and their facts are inaccessible. A large percentage of business failures is directly due to the absence of

proper accounting or the inability to read and understand clearly its records.

2. The Work of Accountancy

Accountancy has been defined as the profession which has to do with the recording, presenting, and verifying of facts concerning the acquisition, production, conservation, and transfer of values. This definition, like other exact definitions, would need considerable elaboration to give a full and clear understanding of the aims and methods of modern accountancy. It furnishes, however, a logical and convenient classification of the work of accountancy into three main functions:

1. Recording the financial transactions of a business.
2. Summarizing the results and thus showing the effect of these transactions upon the business.
3. Verifying the accuracy of the values shown on the books and records.

The first two volumes of the present set, i. e., "The Theory of Accounts," and "Constructive Accounting," discuss the recording of the financial transactions of a business in its various phases, and also consider the second function, statement-making, in a preliminary way.

The third volume, "Cost Accounting," deals with that special phase of accounting which concerns the cost of production.

The fourth volume, "Advanced and Analytical Accounting," presents some of the more difficult phases

involved in recording financial transactions and discusses statement-making and certain phases of auditing.

The fifth volume, "Illustrative Accounting Problems," consists of problems illustrating the entire subject matter of the preceding volumes.

3. Recording Financial Transactions

In recording financial transactions the first responsibility of the accountant is to see that the current transactions of the business are accurately entered, properly classified, and so grouped that the total sales, purchases, and other significant figures for any period can be ascertained at any time. This is the work of the routine bookkeeper, but the ability to perform or direct this work for a business house demands a thorough understanding of accounting principles, their theory and practice. These are presented in, and form the subject matter of, the present volume.

All the ordinary and usual business happenings can be properly recorded by any intelligent bookkeeper without the aid of a professional accountant, if the system of accounts which the bookkeeper is using is adequate. Unusual and peculiar financial transactions, however, are sometimes very difficult to record so that their exact nature will be apparent. It is necessary so to set them down that the rights of all parties concerned may be accurately determined from the evidence of the entries, and it is here that the routine bookkeeper sometimes fails. When he does, the accountant is later called upon to adjust or correct the incomplete or erroneous entries—something that is often difficult and sometimes impossible.

The accountant is vitally interested in the correctness of the bookkeeping procedure, as upon this largely depend the safe conduct of the business and the ease and accuracy with which the final results can be summarized and verified.

4. Constructive Accounting

The accountant must not only be conversant with the form and design of the bookkeeping records commonly used, but he must be capable of devising and installing systems of accounting adapted to record the transactions of any particular business. This is termed constructive accounting.

In the design and installation of these various systems the work of the accountant has been likened to that of an architect. The analogy holds in that before the accountant can go to work he must, like the architect, ascertain the needs of his client and the purpose to be served by the system (or building) before the plans can be drawn. A stock or standard accounting system guaranteed to work smoothly in every business of a certain kind or class is no more feasible and practicable than would be a standard or stock building plan guaranteed to meet the needs of all requiring office buildings or factories, or dwelling houses. There are, however, certain principles of construction, roughly analogous to the principles applied by the architect, as well as certain practical expedients in the way of books, rulings of forms, office short-cuts, and the like, with which the accountant must be familiar. When he has acquired a knowledge of these he can intelligently plan a system which will be free from needless complexities

or formalities, and at the same time give the information required in any given case with a minimum expenditure of time and effort.

Constructive accounting with the fundamental forms, records, and procedure upon which all special systems are more or less based is treated in Volume II of "Business Accounting."

5. Advanced Accounting

The second general division of the accountant's work is the presentation of the facts concerning financial transactions during a certain period in the form of clear and logical statements. An accountant who has merely ascertained and recorded the facts of the case before him has no more finished his work than has a lawyer who has merely ascertained and recorded the facts in a case in which he in engaged. The accountant has still to present his facts in a way to make the financial history of the business intelligible to his client, just as the lawyer must present his facts in such a way as to convince a jury or the court. As a means to this end the facts shown by financial statements are, when necessary, fortified by exhibits or schedules of supporting figures, the whole being usually supplemented by comments in narrative form.

The arrangement of the figures in the exhibits and schedules so that they will not be misleading is an art which is not easy to acquire. Figures may be true but at the same time misleading. For example, the average net profits of a business for a given period of years may be truthfully shown, but if the net profits have been decreasing steadily during the period covered, and this

vital fact is not stated, an estimate of future profits based upon the given average would be misleading. A careful accountant would not report the average in such a case without a qualifying statement or explanation calling attention to the continued decrease so that no one could be misled into considering the average as indicating the present earning power of the business.

The accountant's report or statement is sometimes used for publicity purposes and in this case he must make his report so clear that it may be understood by anyone, even though unfamiliar with accounting.

In Part IV of Volume IV, "Advanced and Analytical Accounting," the subject of preparing statements and reports is taken up.

Both in recording the financial transactions of a business and in preparing its statements and reports, certain matters of unusual complexity or difficulty—real or apparent—are encountered. Reserves must be established; amortizations must be made; consolidated balance sheets and statements may be required. The more difficult phases of accounting procedure such as these are also treated in Volume IV.

6. Audits and Special Investigations

The final division of the accountant's work is the verification of the results of financial transactions as shown by the statements submitted and the supporting records. This includes:

1. Auditing, which may be defined as the examination of the books and records of a business so that any inaccuracies may be discovered and its condition may be exactly determined.

2. Special investigations, which are not complete audits, but are examinations undertaken to discover or demonstrate particular facts or conditions.

The point of view of the auditor is that of an impartial scientific investigator. In digging out the facts as to the result of business transactions, it is necessary to do much more than test the arithmetical accuracy of the books and other records. The books are intended to record the financial history of the business and the investigator must not only ascertain whether or not the record is accurate, but in addition whether it so states the facts that it is clear, impartial, and true.

The auditor must learn the history of the business under examination from the accounting records or by any other means available to him. The books of account when written by bookkeepers who lack the historical point of view or the technical accounting ability to express facts completely and unequivocally, do not always properly record the history of the business. Just as a person untrained in the art of writing would fail to write a reliable history, so a bookkeeper, untrained in recording completely and correctly all financial facts, would fail to prepare a record of financial transactions which would be complete and historically accurate. The auditor must be able to verify and supplement the bookkeeping records so as to discover the facts in their completeness.

Methods of verification and of correct interpretation of the financial facts as exhibited by statements or recorded on the books are considered in Volume IV, "Advanced and Analytical Accounting."

7. Cost Accounting

Volume III of "Business Accounting" discusses the subject of cost accounting, which involves a specialized application of the principles and methods developed in the preceding volumes. It covers both the operation and the interpretation of systems of cost records for manufacturing businesses, where it is desirable to know the cost of making each article or class of article.

Cost accounting is a comparatively new development, but its importance as the chart and compass of sound and alert factory management is being increasingly recognized. So far it has been developed chiefly in connection with manufacturing concerns, either as a means of detecting wastes and inefficiencies and raising standards of performance, or because the factory is obliged to sell its products in a highly competitive market and must therefore know its costs in order to continue to do business. It is, however, just as important to determine the cost of operating or selling as the cost of production, and this volume treats the subject as fully as its growing importance demands. The successful business man of today, whatever his line of activity, must give the closest attention to the cost of doing business to find out exactly how much profit he is making, or what loss he has incurred on every article made or sold, on each piece of work undertaken, and on each of the departments into which his business is divided.

8. Accounting Problems

Practice in the application of theory is as necessary to the mastery of accounting as it is to the mastery of

any other technical subject. To provide this essential practice which alone leads to proficiency in the principles and theories explained in the first four volumes, Volume V is wholly devoted to a series of accounting problems. These are intended to cover the principles of accounting given in the four preceding volumes and have been selected to fit in with and illustrate their text. The student of accountancy who masters the information of the preceding volumes and works out the application of this same information in Volume V, should acquire that fundamental grasp of the theory and practice of accounting which distinguishes the accountant from the routine bookkeeper. Among the problems presented are many which have been given in the C. P. A. examinations of the various states. Some of these are to be found in existing volumes of accounting problems. Many of the problems, however, are not found elsewhere, either having been given in accounting examinations subsequent to the date of publication of the other volumes referred to, or having been constructed specially for the purposes of these books.

9. The Accountant's Training

The accountant who wishes to rise to the higher ranks should come to the study of his profession with a fairly liberal education, and in addition, some considerable knowledge of the principles and practices of modern business. He should have a complete knowledge of such parts of the law of his state and the country at large as relate to business transactions. He should also have a fair understanding of the general principles of economics. Beyond this, he must, of course, have a

very thorough knowledge of the principles of bookkeeping and accounting, which must sooner or later be supplemented by actual commercial practice.

The accountant may be conceived as standing at the apex of a pyramid whose base is economics. Economics covers the fundamental principles which control the general relations of man to man, such, for example, as the so-called law of demand and supply. Based upon economics and somewhat narrower in its scope is man-made law. Law determines the particular relations of man to man. Since law is based upon economics, it cannot permanently and successfully run counter to economic principles. Based upon law and considerably narrower in its scope is accounting, which defines most of the particular relations of man to man. As already stated, standing at the apex of this pyramid is the accountant, who applies the rules of accounting with a knowledge of law and an appreciation of economics.

The professional accountant must be able to take any modern business and devise for it a system of accounts which will adequately serve its accounting needs; he must be able to summarize and present the financial facts shown by these or any other accounting records in approved statement form, and be able to verify such statements when made by other persons; he must be able to examine books of account so as to ascertain whether or not they have been correctly kept, what the profits and losses have been, and whether or not cash or any other asset has been lost or stolen. He must be able to do all these things in such a way that those untrained in the art of accountancy will readily understand the conclusions he draws and will

have confidence in the soundness of his judgment, the correctness of his interpretations, and the impartiality of his conclusions.

10. Public Accountants

Constructive accounting and auditing must usually be done by professional accountants who perform such work for any business which may engage them, receiving a fee in return which is usually fixed at a rate per diem. Such men are sometimes called expert accountants, but a better name and one more generally used, is that of public accountants. Practically in all states laws have been passed which permit public accountants to take an examination given by a state board. If the accountant passes this examination and complies with certain legal requirements concerning preliminary education, age, and experience, the laws designate him as a *certified* public accountant.

To provide the public with a further certification, the leading accountants throughout the country are organized in an association known as the American Institute of Accountants. This body conducts its own examinations and admits to membership all successful candidates whether or not they have been certified by any of the states.

Any person may call himself a public accountant or an expert accountant, or may use any other similar title which does not imply certification. But no person is permitted to call himself a certified public accountant unless he has passed the state examination and has complied with the other legal requirements. It is thus evident that there is no way of ascertaining, from the title

assumed by an accountant who is not certified, whether or not he is competent to do work he undertakes to do. Needless to say, every certified accountant is no more assuredly competent than every lawyer or doctor is assuredly competent, but certification by state law or admission to the American Institute of Accountants fixes a standard by which ability may prima facie be gauged.

CHAPTER II

PRELIMINARY INFORMATION

1. Essential Terms

Every vocation has certain words and terms peculiar to its practice. Sometimes these are new words coined to fill the need. More often they are words already in use that are taken over and given a special meaning remote from their common acceptation. The word "bookkeeping" and the word "account" have both been borrowed in this way and given a purely technical meaning.

A "bookkeeper" is not a keeper of books—a librarian—but instead, one who records financial transactions, which work is called "bookkeeping." An "account" is not a description of something that has happened, but an orderly record of values paid to or received from a particular person or relating to a tangible or intangible thing. The books in which such records are kept are called "books of account" and the man who is trained in the correct method of recording financial transactions, grouping them into accounts, classifying these accounts according to their nature, and then comparing and analyzing their results, is called "an accountant." An accountant differs from a bookkeeper in that he possesses or is assumed to possess a higher degree of skill and ability. The exact line of demarcation between the two cannot be rigidly drawn.

One definition of "accountancy" has already been

given in Chapter I. Another definition is that it is the science and practice of accounts.

An "account" is an orderly statement of the "debits" and "credits" pertaining to financial transactions with a particular person or concerning some subject matter of the particular enterprise.

A "debit" is an entry (some value entered in a bookkeeping record) against a person and in favor of the business or against something of value or some expense and for the use of this thing in the business. "Dr." is the symbol sometimes used by bookkeepers to designate a debit entry. "Mark Holden, Dr., $10" would mean that the business had paid, or in some way transferred to, Mark Holden value to the amount of $10, and that this amount was "charged" or debited against him in favor of the business. "Advertising, Dr. $50," would mean that $50 had been paid or an obligation to pay that amount had been incurred for advertising for the use of the business and that this amount was charged against advertising by making a debit entry on the business books.

A "credit" is an entry in the records in favor of some person and against the business, or to record an income of the business. "Cr." is the bookkeeping symbol to indicate such an entry. "Anson Merritt, Cr. $25," means that Mr. Merritt has paid or has given goods or services to that amount and that he has been credited on the books. It shows that the business owes him. (See page 176.)

The foregoing definitions are of necessity incomplete. They will be amplified as the need arises with the explanation of different kinds of financial transac-

tions. Other technical words and terms are used in accountancy, often in a sense peculiar to the subject. Their meaning must be explained and thoroughly grasped if the subject is to be intelligible. Therefore, this and the following two chapters discuss the most common of these words and expressions and to some extent illustrate the business situations in which they are ordinarily used. Other words and terms peculiar to special phases of accounting will be explained in the text as they are used.

2. Definition of Sole Proprietorship

There are three principal forms of business organization: (1) the sole proprietorship; (2) the partnership; (3) the corporation.

The simplest of these three is the business owned and managed by one person conducting business by himself. While large business enterprises sometimes belong to sole proprietors, this form of business organization is usually confined to professional practices and the conduct of small businesses.

3. Definition of Partnership

An organization of two or more persons by agreement, oral or written, whereby they conduct a business jointly, sharing their profits and losses in certain proportions, constitutes a partnership and the persons forming it are partners. A partnership is generally called a firm. Thus, if Albert Curtis and John Gould agree to conduct business together, each having some sort of proprietory interest in it, they form a partnership. They would then probably call their organization a

"firm," and other persons who do business with them would use the same word, because it is shorter and easier to say than "partnership." Similarly, each partner would be known, colloquially, as a member of the firm. It is incorrect to use the word "firm" in connection with any form of business organization other than the partnership.

4. Definition of Corporation

A corporation is a group of individuals, usually three or more, authorized by law to act in certain respects as one person. A corporation is often defined as an artificial being created by law and composed of individuals acting under a common name. The word "company" is applied to a corporation in the same way that the term "firm" is applied to a partnership and for the same reasons. Thus, if Albert Curtis, John Gould and Horace Hull organize a corporation, they would generally refer to their organization as a "company." They would not be members of a firm; they would be stockholders in a company and probably, although not necessarily, officers therein.

5. Relation Between Proprietor and Business

Whatever form of organization may be used, it should be borne in mind that for accounting purposes the business must be considered as an entity apart from the proprietor. In other words, the proprietor must be treated as if he were completely detached from the working organization, but owning certain rights and incurring certain obligations in connection with the business. This status of the proprietor is clearly defined

in the corporate form of organization, where the proprietor, as a stockholder, is in every respect a different person from the corporation. It is less clearly marked, but no less important, in the partnership and the sole proprietorship.

Some writers explain the proprietor's distinctive relation to the business by considering the bookkeeper as representing the business and thus as accountable to the proprietor. This seems fanciful and without merit because the bookkeeper or the accounting department has no title to any of the business property and is under no obligations except those of employees. The business should be regarded as a distinct entity without considering any person within its organization as its representative.

Statements made throughout this volume to the effect that "the business" owns certain property or is under certain obligations are based upon this distinction between the proprietor and the business. As a matter of law, in some of the instances the title would be vested in, and the obligation imposed upon, the proprietor himself personally; but correct accounting is facilitated by keeping in mind this conception of the business as a distinct entity, i.e., as having a separate existence and thus being capable of holding title to property and fulfilling obligations.

6. Definition of Assets

The object of conducting business is to procure more property, more things of value, than the proprietor has when he begins business. The things of value or property owned by the business are called

"assets." An asset may be anything of value, such as cash, merchandise, horses, wagons, machinery, tools, typewriters, buildings, and land. To constitute an asset, the property in question must be owned by the business. If in a shirt-waist factory the sewing machines are rented, they do not constitute assets of the business, because while they are things of value used in the business, they are not owned by it. They would, however, be assets of the sewing machine company which owned them.

If the business sold goods on credit, the person buying them would owe the business and would be a debtor. The amount he owed would be an asset of the business.

Assets are sometimes called "resources," but the latter term is not in common use, and for this reason is not employed in this book.

7. Definition of Liabilities

When a business secures assets or services of some sort in exchange for cash or other property, it is said to buy or purchase the assets or services acquired, and when it delivers the cash or other assets in exchange to the person from whom the purchase was made, it is said to pay for them. Now in the conduct of business it is not customary always to pay for assets or services at the exact time of purchase. The exchange may be completed later; that is, payment may be made on the next day or at some future time. In that event the purchase is said to be "on credit." The length of time for which credit is thus extended is fixed by agreement between the parties to the purchase, and may vary from one day to six months or more.

When a purchaser buys on credit, the person from whom he buys is called a "creditor" and the obligation to pay imposed on the purchaser is called a "liability." Thus, liability may be defined as an obligation imposed upon a person to complete an exchange; in other words, to pay for services secured or assets purchased.

When a business pays to settle a liability, both the liability and the cash or other asset which pays it are canceled as far as the business is concerned. The liability ceases to exist and the asset, i.e., the cash paid, goes out of the business.

8. Definition of Capital

The assets of a business are what it has. The liabilities of a business are what it owes. If a business is solvent, its assets exceed its liabilities, i.e., the business owns enough to pay all its debts and have something left over. The amount so left over, the excess of assets over the liabilities is "the capital." The essential nature of capital remains the same regardless of the form of organization. Capital is the excess of assets over liabilities, whether a business be a sole proprietorship, a partnership, or a corporation. The term is an important one and the foregoing is a partial definition solely from the bookkeeping standpoint. The subject will be treated at greater length in the next chapter.

Accounting methods of recording capital and capital changes will be presented in later chapters.

9. Recording Business Information

In order to collect information about the business so that it will be available for the proprietor, or for an

outside person who has a legitimate reason for needing the information, records known as books of account are kept. The recording of such information is known as bookkeeping. The nature of the desired information may be summarized as follows:

1. Information concerning the financial condition of the business; that is, assets, liabilities, and capital.
2. Information concerning the results of operating the business; in other words, its profits and losses.

Information of the first kind will answer such questions as these:

(a) What kinds of property constitute the assets and what is the value of each?

(b) What liabilities does the business owe, to whom and when should they be paid?

(c) Are there any contingent liabilities, that is, liabilities which may become payable in certain contingencies or if certain things come to pass?

(d) Do the assets exceed in value the liabilities; is there any capital in the business?

(e) Is there sufficient cash or other assets which in the ordinary course of business will be converted into cash to meet liabilities which must be paid in the immediate future?

(f) Will the business be able to meet all its liabilities as they become payable?

Information of the second kind will answer questions such as these:

(a) How much profit has been made or how much loss has been incurred by the business in a given period?

(b) What sources of income has the business; in other words, what things does it sell, or what kinds of service does it render?

(c) How much is the income from each source?

(d) What are the expenses of the business?

10. Primary Purposes of Bookkeeping Records

Information concerning both financial condition (assets and liabilities) and the results of operation (income and expense) is needed by the proprietor to enable him to manage the business and plan for its future in the most effective way.

Information of the first kind is needed principally to help him finance the business, to provide for the payment of liabilities as they mature, and to conserve the assets.

Information of the second kind is necessary to enable him to determine what lines of business activity are profitable (if the business has more than one line), and how each kind of expense compares with the income it is intended to produce. He needs it also to compare expenses of the current period with those of a preceding period, and to estimate what the expenses of a succeeding period are likely to be.

The same information of both kinds may be needed by an outsider if he is asked, for example, to sell merchandise to the business on credit or to lend money or to invest money or other assets therein.

11. Definition and Use of Statements

Although information about the business is collected in books of account where it can be found when needed, such information is usually presented to the proprietor or other persons entitled to it by means of written statements. Such a statement may be defined as a written presentation of business information in condensed and summary form. Statements are usually prepared directly from the books of account and when necessary may contain any further information not recorded in such books which may be needed to supplement or make clear the figures taken from the books.

Why is it necessary to present statements to the proprietor or an outside person? Why cannot they get the information by consulting the books of account? In the first place the proprietor rarely has time to "dig" the information he needs out of the books, which usually go into much detail and in a big business are voluminous. Then also he may not understand the methods of bookkeeping and so cannot properly interpret the records as they stand on the books. Further, he may desire the bookkeeping figures in some convenient and condensed form in order to study them away from the office.

All these reasons why such information cannot conveniently be secured by the proprietor directly from the books apply also in the case of outside persons. In addition the proprietor may not wish to give such persons free and unlimited access to his books. In some cases the outsider is entitled only to certain specific information and not to all that the books show. Frequently the office is too busy to permit such an interruption of its routine

as would be caused by an inspection of the books by an outside person. So it is customary to present to the proprietor and to such outsiders as may be entitled thereto, business information in the form of statements prepared from the books of account.

The statement should present the information in convenient form and be so arranged that the reader can easily understand it. In this volume the preparation of simple statements is set forth. In Volumes II and IV the form and arrangement of more complicated statements are shown. The preparation of adequate statements is a difficult art, the successful practice of which requires analytical ability in determining the facts and considerable ingenuity in arranging them so as to present clearly just what the reader of the statement should know.

REVIEW QUESTIONS

1. Explain the terms:
   - Accountancy
   - Account
   - Debit
   - Credit
   - Creditor
   - Proprietor
   - Sole proprietorship
   - Partnership
   - Corporation
   - Asset
   - Liability
   - Capital
   - Statement

2. What are the three forms of business organization mentioned above? Is there any other form?
3. What relationship is shown on the bookkeeping records between a business and its proprietor?
4. Name three things not mentioned in this chapter which may be assets.
5. Give an illustration not mentioned in this chapter of a transaction which would result in the creation of a liability.
6. What two kinds of information about a business are needed by the proprietor?
7. Suggest some questions about a business which might be asked by an outsider who was requested by the proprietor:
   (a) To invest money in the business.
   (b) To sell goods to the business on credit.
   (c) To lend money to the business.
8. (a) How is information about a business collected and recorded?
   (b) How is it presented to the proprietor or any other person entitled to it?
   (c) Why is it necessary to present it in the way you mention?

CHAPTER III

CAPITAL

1. Accounting Definition of Capital

At the outset of a business venture the proprietor himself generally contributes some of his private assets to be used in it and he may make similar contributions at any time. Thereafter most of the assets acquired are bought from trade creditors or procured from other persons outside the organization. Suppose, for example, that a proprietor invests $10,000 of his private cash in a business. In that event the business would acquire an asset of $10,000, but would incur no liability in connection with it—that is, no obligation to pay $10,000 or its equivalent to any creditor. It would be obliged, however, when the business terminated to account to the proprietor for the $10,000, and this obligation on the books to account to him for assets received is designated as "capital."

The capital, which in this case would be $10,000, must not be confused with the cash amount of $10,000. The latter is an asset belonging to the business, in nowise distinguished from goods in stock or other assets; the capital is the obligation to account to the proprietor for his investment, or what is left of it, when the business is wound up and all debts have been paid.

The proprietor may contribute any kind of assets; for example, he may set aside from his private property for use in the business $10,000 in cash, furniture worth

$500, and machinery worth $20,000. The capital then would be $30,500.

If more cash is needed, it may be necessary to borrow it from a bank or other outside source. Such loans, which are usually for short periods with frequent renewals, but which may be for periods of a year or more, do not increase the capital. If the business, in the case suggested above, needs $5,000 more cash and borrows it from a bank, the bank becomes a creditor. While the assets are increased to $35,500, a liability of $5,000 has been incurred. The amount for which the business is accountable to the proprietor remains $30,500. The assets exceed this amount by $5,000, but the obligation to account for this $5,000 is not to the proprietor, but to the bank, a creditor.

Thus capital may be defined as the excess of assets over liabilities. It is not represented by any specific assets; it is merely the obligation of the business to account to the proprietor for the value of the assets in excess of the amount needed to pay creditors, or, in other words, the net ownership of the proprietor in the business. Capital is sometimes called "net worth" but this term is not commonly used. It is sometimes called "investment" but this word is generally used to mean a purchase, say, of stocks or bonds, made with a portion of the non-trading funds of a business concern. Hence, this term will not be used here to mean capital, although a proprietor may properly be said to invest his private assets in his business.

2. Economic Definition of Capital

Accountants should learn the definition of capital

from the point of view of the economist, which differs essentially from that of the accountant. Economics is the science which treats of man's activity in the acquisition, distribution, and consumption of wealth. The economist is interested in studying the results which can be obtained by the use of money or any other property in business. He studies business with the object of ascertaining, for example, how much income should be produced by the use, under certain conditions, of a given amount of money or other property. He is not interested in the source of the money or property used in an enterprise, whether it is contributed by the proprietor or borrowed from persons outside the business organization which is under examination. He is interested only in the total amount of money or other property which is used to produce income, and which he calls capital. From the economist's point of view capital is the total wealth, that is, the total property of the business used to produce more wealth or income. For example, in the illustration given the capital from the economist's point of view would be $35,500.

3. The Accountant's Viewpoint

Now, the accountant rarely studies business in an abstract way; he usually studies a particular business and that principally to determine or define the rights and obligations of the various persons interested in or connected with it; that is, to determine the equities. The accountant desires to ascertain the accountability of persons to the business and of the business to persons. He is interested chiefly in learning the extent of the obligations of persons to the business, as indicated by

accounts with persons indebted to the business, termed in bookkeeping parlance "accounts receivable"; the extent of the obligations of the business to persons, as indicated by accounts with persons who have given credit to the business, and which are termed "accounts payable"; and finally (in a sense) the extent of the obligation of the business to the proprietor—how much the proprietor really owns in the business after making provision for the payment of accounts payable. In other words, the accountability of the business to the proprietor, or his ownership therein after provision has been made for the payment of all accounts payable or liabilities, is the capital. Thus, capital from the accountant's point of view, which will be that of this book, is the excess of assets over liabilities; in the example given it would be $30,500.

4. Definition of Profit

Earlier in this chapter it was stated that the object of conducting business is to procure more assets than the proprietor owns when he begins business. At that point the subject of liabilities had not been introduced. Now that liabilities have been discussed, the statement of the object of conducting business may be modified somewhat, for any new liabilities incurred must be deducted from the value of new assets in order to determine whether or not the object of conducting the business has been attained. This object, stated more exactly, is to secure an increase in assets that are held free and clear; assets that have no liabilities offsetting them. In other words, the object is to conduct the business so as to increase the original capital.

An increase in capital, other than that contributed by the proprietor, is called a profit. For example, if the proprietor invests $10,000 in a business and after conducting it for a year has $15,000 free and clear of liabilities without having made any further contribution, without having withdrawn any money or other assets for his personal use, and without having imposed on the business any of his personal liabilities, the business has made a profit of $5,000.

Profit has sometimes been defined as the amount of earnings left after deducting all expenses and losses; but that definition seems to limit profits to those secured from the operation of the business, whereas they might also be secured in other ways. Later in this book the nature of profits will be considered. At this point it is sufficient merely to call attention to the fact that profits or income are not limited to earnings made by the business in its ordinary operation, but really include all increases in capital *not contributed by the proprietor.* For example, if an asset which was not originally bought for sale, such as a machine used in manufacturing, is sold for more than it cost, the amount of such excess is a profit.

5. Definition of Loss

A loss, which is the converse of a profit, may be incurred in either of two ways. It may be incurred in the ordinary conduct of the business as a result, for instance, of selling goods at less than cost, or it may be caused by a sale of some property not intended for sale at an amount below cost. Loss may be defined as any decrease in capital not due to the proprietor's withdrawals.

6. Withdrawals

What the proprietor withdraws from the business is some asset, which is usually money but which may be material or articles of any sort. Frequently, it consists of the merchandise in which the business deals, but which the proprietor can use personally—for example, groceries. The effect is, of course, to reduce capital because the withdrawals reduce assets with no effect upon liabilities.

The withdrawals may be made either directly by taking out the asset, or indirectly by charging the proprietor's personal bills to the business. They may occur weekly, monthly, or at any other time; for instance, when the proprietor withdraws cash to pay a personal expense such as a life insurance premium. Many sole proprietors and partners regularly charge their personal drawings or a certain part of them as salaries and consider those drawings as expenses of conducting business. Later in the book there will be a discussion of when, if at all, the drawings of a sole proprietor or of members of a partnership may be considered in lieu of salaries paid for managerial services. At this point it is better to consider all personal drawings by the proprietor as withdrawals of profits or reductions of capital, which have no effect upon the operation of the business because they are not expenses.

7. Definition of Deficit

It is not correct to define capital as the difference between assets and liabilities, because liabilities may, and sometimes do, exceed assets, and in that case the difference between them is not capital. An excess

of liabilities over assets is termed "deficiency" or "deficit." It is the reverse of capital and is thus a state of fact existing at a particular time. For example, if on December 31, 1919, the liabilities of a business were $12,000 but its assets were only $11,000, there would be a deficit at that time of $1,000. Deficit should not be confused with loss because loss instead of being a state of fact at a particular time is the result of operating a business so that during some period of time the expenses exceed the income. Notwithstanding a loss during the year ending December 31, 1919, there might have been capital in the business both at the beginning and at the end of the year. Also there might have been a profit during that year, although there was a deficit at the beginning and at the end of it.

At the beginning of a business there cannot be a deficit because every original asset must come, as has been explained, from a creditor or the proprietor. If an asset comes from the proprietor it creates capital. If it comes from a creditor a liability is created. But this liability is offset by the asset itself, so that at the beginning there must be either capital or an exact balance between assets and liabilities; there cannot be a deficit. After a business has been in operation a deficit may be caused by a loss of assets due to operation or a withdrawal of assets in excess of the amount of capital standing to the credit of the proprietor.

8. Summary of Capital Changes

The following analysis of changes in capital due to profits, losses, contributions, and withdrawals shows how assets come into and go out from a business.

An asset may come from any one of three sources:

1. It may come from the proprietor as a contribution of capital.
2. It may come from persons other than the proprietor. In that case a liability is created in favor of the person from whom it comes or else an asset is delivered in exchange.
3. It may be procured as a result of a profit made by the business, as for instance, when an asset is exchanged for one of greater value. In that case capital is increased.

An asset can pass out from the business in any one of three ways:

1. It may be used to pay a liability; both the asset and the liability are then canceled, and there is no effect on capital.
2. It may disappear as a result of a loss incurred by the business, e.g., the exchange of an asset of a value greater than that of the one received; or it may be used to pay for one of the expenses of the business, e.g., salaries or rent.
3. It may be withdrawn by the proprietor for his personal use. Here capital will be decreased because assets are decreased and liabilities are in no way affected.

The various causes of changes in capital which have been described above may be summarized as follows:

1. Capital is increased by new assets procured as a result of a profit made by the business.

2. Capital is increased by assets contributed by the proprietor.
3. Capital is decreased by assets which disappear as a result of a loss incurred by the business.
4. Capital is decreased by assets withdrawn by the proprietor for his personal use.

9. Examples of Capital Changes

Many transactions in actual business involve more than one of these four kinds of changes. Such transactions to be clearly understood and properly recorded should be analyzed and each of the above elements recognized and properly treated. Simple examples of each kind are as follows:

1. If merchandise costing $100 be sold for $150 in cash, a new asset, cash, to the amount of $150 is procured in place of the former asset. An additional asset of $50 is acquired by the business, and the capital is increased by that amount as the result of a profit.

2. If the proprietor invests in the business $1,000 from his personal funds, the capital is increased by the amount of this new asset.

3. If merchandise costing $100 be sold for $75 in cash, a new asset, cash, to the amount of $75 is procured in place of the former one. There would thus be a disappearance of asset value to the amount of $25 due to a loss. The capital is decreased by the amount of the asset which has disappeared because of this loss.

4. If the proprietor withdraws $2,000 in cash for his personal use, capital is decreased by the amount of the asset withdrawn.

REVIEW QUESTIONS

1. Define capital. Is capital a liability?
2. Distinguish between accounting capital and economic capital.
3. Define:
   (a) Profit
   (b) Loss
   (c) Withdrawals
   (d) Deficit
4. Draw up a set of rules helpful to a bookkeeper in showing him how assets and liabilities come into and go out from a business, so that the changes in the capital may be properly indicated.

CHAPTER IV

DOUBLE-ENTRY BOOKKEEPING

1. Kinds of Bookkeeping

In Chapter II it was stated that business information is collected in books of account and that the making of such records is known as bookkeeping. The kind of bookkeeping, the amount of detail information, and the method of collecting and recording it vary somewhat with the size of the business but more particularly with the kind of information needed. If figures as to the financial condition of the business only are required, i.e., if the proprietor merely wants to keep informed regarding his assets, liabilities, and capital, and regarding the total changes in the capital from time to time, the bookkeeping may be simple and the method known as single-entry bookkeeping may be used. (See Chapter XXXIV.) But if the proprietor wants information not only about his assets, liabilities, and capital, but also about the details of his profit and loss, the system of bookkeeping must be more elaborate. It must show all that single-entry bookkeeping shows and much more. It must show exactly how much is received from each source and how much it costs to secure each kind of income; in other words, what the expenses are and in each case the exact amount. Bookkeeping which records information in this way is known as double-entry bookkeeping, and such is the method most generally used in business houses.

2. Analysis of a Business Transaction

Every business transaction is a transfer of money or money's worth, and involves two essential elements:

1. That which is paid or given.
2. That which is received in exchange or payment.

Upon receiving money or money's worth, the receiver either gives money's worth or money in exchange, or else becomes obligated to do so at some future time. For example, a purchase of merchandise may be for cash or on credit (on account). In either case there is a transfer of money's worth (the merchandise) from seller to purchaser. If the purchase is for cash, the purchaser receiving the merchandise gives money in exchange; if on credit, the purchaser becomes obligated to give money or money's worth in exchange at some future time. If either party should give and not receive, it would be a gratuitous act and not a business transaction.

Every business transaction involves one or more of the three following factors:

1. Money.
2. Money's worth.
3. A personal obligation to give money or money's worth at some future time.

3. Original Entries and Their Grouping into Accounts

In order to keep a chronological record of the business, each transaction as it occurs should be "entered," that is, noted, in some suitable book. Such a book is designated as a book of original entry, i.e., first entry.

If Clark & Fox buy goods from the business to the amount of $35 on account, the double effect would be shown by an entry as follows:

Clark & Fox, Dr.....	$35.00	
Merchandise, Cr.....		$35.00

In addition to this first entry of each transaction, it is necessary for practical purposes to sort or classify these original entries by subjects as well as dates, and this is accomplished by making a second entry of each transaction in another book called a "ledger." In a ledger all the entries concerning a given subject, such as cash or merchandise, are grouped under a heading or caption which is the name of the subject, whether it be a person, money, kind of property, or anything which is money's worth. The resulting collection of entries concerning a given person or subject is called an "account."

The original entries shown would go to two accounts in the ledger—the personal account with Clark & Fox, and the asset or property account with "Merchandise." Every transaction will be finally entered in two ledger accounts, on the debit side of one and the credit side of the other. Hence, the term "double-entry bookkeeping."

4. The Ledger

The ledger is the essential bookkeeping record. The other books merely furnish the assembling places in which are gathered and sorted the transactions as they occur, from which places they pass, after sorting, to the ledger. If the functions of the ledger are first

explained, the uses of the other books or records of original entry will be more clearly and readily understood.

5. Illustrative Transactions

To illustrate further the use of accounts, the following examples are given:

1. I pay $25 in cash for goods purchased. Evidently goods have come in and cash has gone out. Therefore, the account with goods is increased (debited) to the extent of $25, and the account with cash must be decreased (credited) in amount $25. The original entry would be:

Merchandise, Dr.	$25.00	
Cash, Cr.		$25.00

2. I purchase goods from Brown & Sharpe on credit for $100. As before, goods come in. Merchandise account is increased and must be debited $100. I promise Brown & Sharpe to pay for the goods some time in the near future; they have become my creditors. Therefore, an account headed "Brown & Sharpe" must be credited for $100. The original entry would be:

Merchandise, Dr.	$100.00	
Brown & Sharpe, Cr.		$100.00

3. I give Brown & Sharpe my 30-day note for $100; i.e., I acknowledge in writing my indebtedness to Brown & Sharpe for the goods purchased from them, and I promise to pay them cash at the end of 30 days. The indebtedness is changed on my books from a mere memorandum entry (open account), to a written obli-

gation (notes payable) which matures in 30 days. The original entry would be:

Brown & Sharpe, Dr.	$100.00	
Notes Payable, Cr.		$100.00

4. I sell goods for cash $75. My supply of goods has been decreased and I have increased my cash. The original entry would be:

Cash, Dr.	$75.00	
Merchandise, Cr.		$75.00

Since for every debit a credit of an equal amount must be made, or for every credit a debit of an equal amount, the sum of all the debits entered in the ledger must equal the sum of all the credits for the same period. (See also "Rules for Journalizing," pages 175, 176.)

6. The Form of an Account

Accounts may be kept in many different forms. The general practice is to divide the ledger page into two parts—a left-hand half and a right-hand half, each half containing a separate column for the date, the explanation, and the amount. The following form shows the second and third transactions mentioned above recorded, i.e., "posted," in the proper ledger accounts. It will be noticed that each account is divided by a line drawn through the center so that it has two sides.

There is no logical reason for this selection of sides but it is customary to enter items recording liabilities on the right-hand side of an account with the creditor, and items showing that a person has become a debtor on the left-hand side of his account. This practice has

Merchandise (Goods)

1919 Jan.	1	Brown & Sharpe		$100	00						

Brown & Sharpe

1919 Jan.	3	Notes Payable		$100	00	1919 Jan.	1	Merchandise		$100	00

Notes Payable

						1919 Jan.	3	Brown & Sharpe		$100	00

Form 1. Ledger Accounts with Postings

resulted in the right-hand side of an account being known as the credit, and the left-hand as the debit side, and it is furthermore customary to refer to the placing or posting of the items therein as debiting or crediting an account. This same method of debiting and crediting is used to record in accounts transactions other than those with individuals (i.e., accounts with cash, merchandise, and the like), so that throughout the bookkeeping system the accounts are kept "in equilibrium"; i.e., the total of all debit entries should always equal the total of all credit entries in the ledger and in this way the clerical accuracy of the posting is proved in part. This phase of the work will be taken up later (Chapter VII), where methods of testing the accuracy of the ledger postings by means of a "trial balance" are described.

7. The Balance of an Account

When one side of an account exceeds the other, i.e., when the credits are greater than the debits or vice versa, the account is said to have a balance. The balance of an account may be defined as the excess of one side over the other, and it is given the name of the side on which the excess is found. For example, if the debits exceed the credits, an account is said to have a debit balance.

Each side of the ledger account is usually added at the end of each month or oftener if desired; and where the total is not readily apparent it should be entered in pencil in small figures immediately under the last regular entry, which, of course, is in ink. The balance of the account should generally be noted in pencil in the

explanation space on the side of the account on which it occurs.

REVIEW QUESTIONS

1. What is a business transaction?
2. Illustrate the "twofold effect" of a business transaction by:
   (a) The sale of a horse for $100.
   (b) The purchase of a pound of butter for 50 cents.
   (c) The hiring of the services of a window-cleaner for $2.
3. (a) What is an account?
   (b) What is a ledger?
4. Describe the form of an account.
5. How is the balance of an account determined?
6. A piece of real estate was bought on May 15, 1918, for $30,000. Investigation of title costs amounted to $900; sidewalks, curbing, grading, etc., cost $700. The land was sold one year later for $60,000. Make up the account for the land.
7. Paul Masterson owed us $1,000 on July 1, 1919. On July 3, he paid us $100 on account; on August 1, he bought goods amounting to $50; on August 3 he returned goods to us as unsatisfactory amounting to $15; on August 31, he settled his account in full, being allowed 2% discount. Make the necessary entries in his account.

CHAPTER V

DETERMINATION OF CAPITAL OR DEFICIT

1. Method of Ascertaining Capital or Deficit

As explained in Chapter III, capital is the excess of assets over liabilities, and deficit is any excess of liabilities over assets. It is evident, therefore, that to determine the capital or deficit at any time, it is first necessary to ascertain the amount of assets and liabilities. Any excess of the one over the other then represents capital or deficit as the case may be.

Suppose that Charles Warren is going to begin business with $14,500 in cash of his own, and $4,000 of borrowed money, for which he has given his note to his brother. The statement of assets and liabilities would then be very simple; the following form, although not technical, states all the facts. It is prepared in the "running" or statement form, which, as explained later, is frequently used.

STATEMENT OF ASSETS AND LIABILITIES

December 31, 1918

Assets, Cash in Bank	$18,500.00
Liabilities, Notes Payable	4,000.00
Charles Warren's Capital (Net Worth)	$14,500.00

This statement if arranged in more formal accounting shape would be as follows:

CHARLES WARREN

STATEMENT OF ASSETS AND LIABILITIES

As of December 31, 1918

Assets		*Liabilities*	
Cash in Bank.....	$18,500.00	Notes Payable.....	$ 4,000.00
		Charles Warren, Capital.	14,500.00
	$18,500.00		$18,500.00

It will be noticed that the entry of the proprietor's net worth on the right-hand side makes the statement balance. The capital is entered on the right-hand side as if a liability. It is not *legally* a liability, but for accounting purposes it is treated as a liability. The business is *accountable* to the proprietor but is not legally liable. In the event of insolvency all the legal liabilities would have to be paid before the proprietor would have any claim on any of the assets.

2. Statement of a Going Business

If Charles Warren continued in business, he would want a statement showing his capital or net worth at the end of every quarter or six months or year. Assume that at the end of six months the business had assets and liabilities as shown in the following schedule; this schedule being only an informal list prepared without regard to accounting or bookkeeping form and therefore not showing totals or the computation of the present capital.

Assets

Cash		$ 1,500.00
Notes Receivable:		
B. Alton	$1,000.00	
C. Dodd	1,000.00	2,000.00
Accounts Receivable:		
A. Henry	$2,000.00	
C. Traver	2,500.00	
K. Dorr	3,000.00	
E. Smith	500.00	8,000.00
Merchandise		7,500.00
Furniture and Fixtures		300.00
Machinery and Tools		2,000.00
Land and Buildings		12,000.00

Liabilities

Notes Payable:		
Kerr & Co		$ 1,000.00
Accounts Payable:		
Kerr & Co	$2,000.00	
A. R. Butler and Son	4,000.00	
Rover & Jones	3,000.00	
Sunset Merchandising Co	4,000.00	13,000.00

By listing the foregoing assets and liabilities in a formal statement it is seen that Charles Warren has assets to the amount of $33,300, of which amount $14,000 is owing by the business to various creditors. The excess of assets over liabilities, $19,300, represents the capital at that time in the business. Such statement is given below:

CHARLES WARREN

STATEMENT OF ASSETS AND LIABILITIES

As of June 30, 1919

Assets		*Liabilities*	
Cash	$ 1,500.00	Notes Payable	$ 1,000.00
Notes Receivable	2,000.00	Accounts Payable	13,000.00
Accounts Receivable	8,000.00		
Merchandise Inventory	7,500.00	Total	$14,000.00
Furniture & Fixtures	300.00	Charles Warren, Capital	19,300.00
Machinery & Tools	2,000.00		
Land & Buildings	12,000.00		
	$33,300.00		$33,300.00

This statement is brought into balance by the insertion of Charles Warren's capital on the right-hand side. It would similarly be brought into balance by the insertion of "Deficit," if there were one, on the left-hand side. Bringing the statement to a balance in this way is known as "establishing its equilibrium," and in connection with double-entry bookkeeping the statement itself is known as a "balance sheet."

3. Recording Subsequent Facts in Accounts

Financial condition changes constantly as business operations take place. It would be possible to show the altered condition at the close of each day by making a new statement or by changing the figures in the first statement. For instance, if merchandise of $1,500 were purchased on credit, the asset merchandise shown on the statement in § 2 would be increased from $7,500 to $9,000, and the accounts payable from $13,000 to $14,500. In this example an increase in assets is

exactly offset by an increase in liabilities. The equilibrium has not been disturbed. If, then, a customer paid $500 on his account, the asset cash would be changed from $1,500 to $2,000, and the accounts receivable from $8,000 to $7,500. In this second case we have an increase in one asset offset by a corresponding decrease in another asset.

It is obvious that when business transactions are numerous, to keep track of these fluctuations by making continuous daily changes in the balance sheet would be utterly impossible. Therefore, accounts are opened in the ledger for each kind of asset and liability and for the capital of the proprietor. The equilibrium established in the opening statement is preserved in the ledger accounts by entering each item on the same side of its appropriate account as that on which it appears in the statement. Thus amounts representing assets are entered on the left side of the proper accounts, and those representing liabilities and accountability for capital on the right side. If this procedure is followed it is clear that the total debits in all the accounts must equal the total credits and the accounts will be nothing more than a transcript of the financial statement.

Subsequent transactions can easily be recorded in the accounts by debiting or crediting them, as transactions take place, according to the procedure to be explained in following chapters, and in this way the equilibrium established in the beginning is preserved.

4. Recording Subsequent Facts Showing Profit or Loss

Thus far, accounts relating only to assets and liabilities have been discussed. We have now to consider

accounts relating to expense and income, the nature of which is indicated by their name. Assume that an expense, such as rent, amounting to $300, is paid in cash. In this case there is a decrease in the asset of cash from $2,000 to $1,700, and a corresponding decrease in capital from $19,300 to $19,000. As a second example, suppose that merchandise is sold for $2,000, which is $500 more than was paid for it. Here there is a decrease of $1,500 in the Merchandise account, offset by an increase of $1,500 in the Cash account. In addition we have still $500 in cash received which must be accounted for. Therefore, Cash account is increased $500 as the result of a profit and there is a corresponding increase of $500 in our capital.

Obviously when transactions which affect capital frequently occur, it is a cumbersome procedure to pass every fluctuation through the Capital account on the ledger.

5. The Use of Income and Expense Accounts

The difficulty is solved by the use of income and expense accounts. For example, if the business received a payment of interest the transaction would be recorded:

Cash	$30.00	
Interest		$30.00

Interest, an income account in the ledger, would be credited with the amount received.

If, instead, cash was paid for salaries, the entry would involve the Cash account and an expense account and would be as follows:

Salaries	$40.00	
Cash		$40.00

Salaries, an expense account in the ledger, would be debited with the amount paid out.

6. The Use of the Profit and Loss Account

At the end of some period, as a month, a half-year, or year, all of the income and all of the expense accounts are balanced and these balances are transferred to a ledger account called "Profit and Loss." The balances showing income are transferred to the credit side of the Profit and Loss account. The balances showing expenses are transferred to the debit side of the Profit and Loss account. If the balance of the Profit and Loss account is on the credit side, the business is paying and capital has been increased by the amount of the balance. This balance is then transferred to the credit side of the ledger account with capital. An example of a Profit and Loss account is given in Chapter VIII, where the subject is taken up in greater detail.

REVIEW QUESTIONS

1. Illustrate how one would determine a proprietor's capital when he begins a business with an investment of at least four private assets and with at least two liabilities.
2. Define "deficit."
3. (a) What is meant by the "principle of equilibrium"?
   (b) How is the equilibrium of the ledger accounts maintained?
4. (a) Why could not a balance sheet statement be kept in balance by noting on it the changes caused by each business transaction?

(b) How are these changes grouped and finally brought on the balance sheet?

5. (a) What kind of account would salaries paid be passed through?

(b) What kind of an account would interest received be entered in?

6. (a) What is the account in which all items of income and expense are finally marshalled?

(b) In such an account on which side would losses be entered?

Part II
The Ledger

CHAPTER VI

CLASSIFICATION OF LEDGER ACCOUNTS

1. Importance of Correct Classification

Any science is a science only so far as it classifies and groups the facts on which it is based according to their resemblances. Unless this grouping is done intelligently and is founded on real resemblances and real differences, the facts will fail to state the full truth, the conclusions drawn therefrom may prove erroneous, and the science will not fulfill its purpose of imparting knowledge which is true and admits of no controversy. Accordingly, an accounting system is of value only to the extent that it successfully reveals the true trend of business activity, gathering up the facts as they occur day by day and recording results and effects in terms of figures. Therefore, for the system to do this, business transactions must first be classified under headings which correctly indicate their nature, and the accounts in their turn must be grouped in the same way. Incorrectness and indefiniteness in terminology create confusion, lead to error in the recording of facts and will cause the most elaborate system to break down.

2. Object of Classification

The classification of accounts is determined by the kind of information required on the statements compiled at the end of a fiscal period. The balance sheet, as we have seen, is a condensed list of assets and liabilities,

and the difference between the two constitutes the capital or deficit of the business, as the case may be. The profit and loss statement presents a summary of the balances of accounts relating to income and expense, and the difference between the two constitutes either a profit or a loss. Therefore, every account kept on the general ledger can be classified primarily under one of the five heads enumerated below:

General Ledger
1. Assets
2. Liabilities
3. Capital
} Balance Sheet Accounts
4. Income
5. Expense
} Profit and Loss Accounts

To label an account as belonging to one of the five heads listed above does not, however, go far enough. There are numerous varieties of assets, many kinds of liabilities, various sources of income, and as for the items of expense, these alone may run into a formidable list the length of which will depend upon the size and ramifications of the business and the minuteness with which expenses are analyzed and classified. The underlying idea of account-keeping is to collect and classify like transactions as they occur, thus losing sight of the detail and building up a summary which presents in condensed form the result of the transactions during a given period.

3. Real and Personal Accounts

The balance sheet accounts are known also as real or personal accounts, the latter representing all relation-

ships with persons (debtors, creditors, or proprietors) and the former covering all assets except claims against persons. Logically, all balance sheet accounts are real accounts because they represent real things, tangible or intangible, which actually exist, i.e., assets, liabilities, and the accountability to the proprietor. For convenience, however, accounts with persons, e.g., accounts receivable, accounts payable, and capital accounts, are further classified as personal accounts. They differ from real accounts only in that they concern persons. Reflection will show that every liability account is personal because it shows the relation with a creditor. Capital account is personal because it represents the accountability of the business to a person known as the proprietor. Notes receivable and notes payable are personal accounts, the only difference between them and accounts receivable and payable being in the form or evidence of the obligation.

4. Nominal Accounts

The profit and loss accounts are called "nominal" because they are accounts in name only. They are not real accounts because they do not represent real things having present existence like assets, liabilities, and the accountability to the proprietor. Instead, they represent increases or decreases in capital resulting from income or expense. Such increases or decreases could logically be credited or debited directly to the capital account but that would not be convenient bookkeeping because it would unduly complicate the capital account and would not accumulate information concerning income and expense items in statistical form. Therefore,

temporary accounts are opened for them. At the end of the fiscal or accounting period, these nominal accounts are closed into the capital account (through a profit and loss account as noted in Chapter V). In the meantime these accounts are in effect suspended debits or credits properly belonging in the capital account. They are in the form of accounts, but they are accounts in name only and thus are called nominal.

5. Extension of Classification of Accounts

From this it follows that if statements presented at the end of a period are to show the results of operations during the period, the original analysis and record of transactions must be made with great care. Therefore, as an aid to this analysis and the correct classification of transactions in the first instance, the five kinds of accounts listed in § 2 are further subdivided into certain fundamental groups, the nature of which is to some extent indicated by their titles shown below:

1. Asset Accounts
   - Fixed or Permanent
   - Current or Floating
   - Deferred Expense
2. Liability Accounts
   - Fixed or Permanent
   - Current or Floating
   - Deferred Income
3. Capital Accounts
   - Proprietors, Personal
   - Proprietors, Capital

4. Income Accounts
   - Sales
   - Income from Investments or Securities Owned
   - Miscellaneous Income
5. Expense Accounts
   - Manufacturing Cost
   - Selling Expenses
   - General Administrative Expenses

6. Further Subdivision of Groups of Accounts

The accounts of every mercantile or manufacturing business may be classified under the above groupings or headings which indicate broadly the purpose for which a particular account is opened and the effect of its balance upon the statement of financial condition. Each of these groups may be further subdivided into as many accounts as are needed to classify the various kinds of transactions which fall under different heads within the group. Thus, the group of permanent or fixed assets may consist of accounts kept with land, buildings, machinery, furniture and fixtures, delivery equipment, office equipment, good-will, and any other asset which is carried on the books at a valuation fixed or determined by its cost to the business and not by the amount realizable at an enforced sale.

At this stage of the discussion nothing is to be gained by appending a complete list of the accounts most commonly opened under the above groupings, and the reader is referred for such a list to Chapters XXXVI and XXXVII. The point for the student to note is that if the function of a group to which a particu-

lar account belongs and the effect of this group on the balance sheet or profit and loss are thoroughly understood; and if furthermore an adequate number of accounts are opened and so grouped and entitled on the ledger that the classification of transactions can be readily and correctly made, then the recording of entries in their proper accounts is simplified and the correct debiting and crediting of the amounts involved is assured.

7. Classification as an Aid to Correct Bookkeeping

The reason for this can be made clear by means of an illustration. Assume that on the opening of a business an invoice is received for several filing cabinets, a supply of filing cards and folders and some office stationery. The fixed assets of a business represent an investment of money in something of permanent value to, or of more or less permanent use in, the business. As the filing cabinets obviously belong to this category, an asset account entitled "Office Furniture and Fixtures" is opened in the section of the ledger devoted to the group of fixed asset accounts and debited with the price of the cabinets. Asset accounts, as we have seen, normally have debit balances. Therefore it is easy to remember that the purchase of an asset is recorded by debiting the account describing the thing purchased.

The invoice also covers the purchase of other articles which will not be permanently used in the business. Assuming that a year's supply of filing cards and folders has been bought and that the office stationery is for current consumption, to be taken into use at once, then it is apparent that the cost of the cards and

folders should be deferred and spread over the year's operations, while the stationery represents an expenditure for the immediate needs of the business, i.e., an expense. A purchase the cost of which is to be deferred and charged gradually to future operations is none the less an asset though an asset of rapidly diminishing value while the supply lasts. Therefore it is debited to some suitable asset account such as Office Supplies, which is opened in the section of the ledger devoted to accounts in which such deferred charges are entered. The mere opening of an account in this part of the ledger indicates that at the close of the fiscal period part of the asset value shown therein should be charged to current operations, as an expense or diminution of profit. The method of doing this will be discussed later when the Profit and Loss account is considered.

The stationery, as we have seen, is for current needs and constitutes one of the expenses of carrying on or administering the business. Therefore, an account headed "Office Stationery" or other suitable title, is opened in the general administrative expense section of the ledger. As all expense accounts, for reasons previously explained, normally have debit balances, no mistake can be made as to the side of the account on which the expense item should appear; while the inclusion of the account in the expense section of the ledger indicates that its balance is to be closed out at the end of the period to the debit of Profit and Loss account. This procedure will be described in later chapters. Here it is sufficient to draw attention to the advantages of so grouping accounts that the nature of the entries in each case (whether a debit or credit) is

thereby indicated as well as the disposition of the amounts shown therein at the close of the fiscal period.

8. Making Offsetting Entries

The credit entry or entries to offset the three supposititious debits just discussed need only brief comment. Each purchase transaction creates a current or floating liability. The liability may be extinguished (1) by a prompt cash payment, crediting Cash, or (2) it may be entered on the books by crediting the person from whom the purchase is made if on account, or (3) Notes Payable account may be credited if a note is given in payment. Creditor's account and Notes Payable account are kept in the section of the ledger devoted to the classification of current liability accounts. As a liability account must have a credit balance, an entry in this section of the ledger is either credited to show an increase of liability or debited to record a payment when a liability is extinguished.

9. Classification an Aid to Preparation of Statements

In addition to simplifying the work of bookkeeping and insuring the correctness of the records in the ways explained, the classification of accounts also facilitates the preparation of financial statements at the close of a fiscal period. If, for example, all expense accounts are grouped in one section of the ledger and income accounts in another, the account balances shown in each section furnish the data for compiling the profit and loss statement. As asset and liability accounts are grouped under suitable headings, the sum of all the balances of the accounts within a group constitutes the

figures which appear under that head on the balance sheet. The method of grouping and classifying accounts on the ledger should be such as to facilitate the presentation of the data summarized on the balance sheet.

10. Asset Accounts

Fixed assets, it may here be repeated, are those which are permanent in nature and with which the business is carried on. Thus, an account may be opened within the group of fixed assets for tangible things such as buildings, machinery, patterns, etc., or intangible things such as patent rights, leaseholds, good-will, etc., providing the thing specified in the account heading is of more or less permanent value to the business.

Current assets, known also as "floating" and "quick" assets, consist of cash and those assets which in the ordinary course of business *will* be converted into cash. Attention is invited to the use of the word "will." The test of a current asset is not whether it *can* be converted into cash, more or less quickly, but whether it *will* be so converted in the ordinary course of business. Examples of current assets are cash, accounts and notes receivable, and merchandise.

"Deferred Expense" is a general term which covers any expense or service paid for but not immediately absorbed by the operations of the business; e. g., insurance premiums paid in advance, advertising paid in advance or advertising supplies not exhausted, office or stable, or storeroom, or fuel supplies not exhausted, and so on. Such services paid for or supplies on hand are just as much an asset to the busi-

ness until exhausted as is a piece of machinery until it is worn out, or a patent right until it expires. While such assets as these are as a rule of small value in comparison with the fixed and current assets, their inclusion on the balance sheet is essential for the correct showing of financial conditions.

For the proper debiting and crediting of the numerous accounts within this group see Chapters XXXVI and XXXVII.

11. Liability Accounts

Fixed liabilities represent obligations to pay certain sums at future fixed dates, the terms of payment being as a rule legally stated by a mortgage bond, a debenture bond, or any other formal instrument.

Current or "floating" liabilities include all liabilities except those classed as fixed; e.g., accounts payable, notes payable, taxes due but not yet paid (accrued taxes), accrued interest on mortgages or on bonds, etc. The practical distinction between fixed and current liabilities is usually the length of time the obligation has to run. Liabilities maturing within one year are commonly called current.

Deferred income represents the obligation to render service or deliver an asset at some future time for which the consideration has already been received. Rent may have been received for a given period which extends beyond the end of the present fiscal period. To classify such an item in an income belonging to the profit and loss section of the ledger would be incorrect because only part of the rent represents a profit of the current period. The balance must be carried on the books as deferred

income until the period covered by the rent has expired. A cardinal principle of sound accounting, as will be seen later, is that no profit shall be shown on the books unless earned. Deferred income items are outside the regular routine of ordinary mercantile business. When they exist, however, they should be indicated on the balance sheet and on the books.

The debits and credits to the accounts commonly found in the liability group are shown in Chapters XXXVI and XXXVII.

12. Capital Accounts

The operation of this group of accounts will be more clearly understood as the subject is developed in later chapters. For the present all that is necessary is to state that the primary function of the capital accounts in all three types of business is to show the excess of assets over liabilities and to whom the business is accountable for this excess. The various accounts which usually appear in the capital section of the ledger with the usual debits and credits in each case are shown in the chapters at the end of this volume.

13. Income Accounts

Among the groups of accounts which record income, much the most important is the Sales account. The main source of income in every business is the sale of something, whether this be goods manufactured, merchandise bought for resale, or a service of some kind. Sales may be recorded in a number of accounts, depending upon how sales are classified—by lines, territories, departments, salesmen, etc. Other sources of revenue,

as for instance from investments, royalties, etc., fall within the income group, if such income is clearly a profit due to the operations of the business during the present fiscal period. Otherwise the revenue must be included in the deferred income class and only that portion of it which is applicable to the present period transferred to Profit and Loss account at the close of this period. This procedure will be explained and illustrated later. For the present all that need be borne in mind is that the record of the receipt of income is invariably made to the credit of some suitable income account. The usual income accounts opened and their debit and credit entries are given in the closing chapters of this book.

14. Expense Accounts

The accounts within this group are usually more numerous than those under any other head. The cost accounts of a manufacturing concern are in themselves capable of being recorded in almost endless detail and variety. As, however, these constitute a separate branch of accounting with a field peculiarly their own, the subject is separately covered in Volume III and nothing further is here required than to note their existence. The expense accounts of a mercantile business can usually be subdivided under the heads of "Selling" and "Administrative."

Selling expense includes such items as advertising, agents' commissions, salesmen's salaries and commissions, expenses of shipping and credit departments, sample cases, freight outward, clerical help exclusively employed in sales department, etc.

Administrative expense comprises all expense connected with the operation of a mercantile business other than that classified as selling expense. Examples of this class of expense are officers' salaries, directors' fees, office supplies, postage, telephone, taxes, legal expenses, depreciation, and all other expenditures made for the general conduct of the business.

All such expenditures are invariably debits to some suitable expense account, the debit balance of which in the case of mercantile accounts is closed out to Profit and Loss account at the end of the fiscal period. This procedure is explained in Chapter VIII; and the expense accounts most commonly opened by a trading concern, with illustrations of their debits and credits, are shown in Chapters XXXVI and XXXVII. The study of those chapters in connection with the descriptive definitions given in this chapter will help to fix clearly in mind the groups or classifications under which all accounts fall and the proper disposition of transactions within them.

REVIEW QUESTIONS

1. What is the purpose of classifying accounts?
2. How may the accounts, kept in the ledger be classified? Define each class.
3. Classify the following accounts:

   Insurance
   Wages
   Investments
   Mortgage Payable
   H. Osborn, Proprietor
   Returned Purchases
   Taxes

Returned Sales
Patents
Tools
Real Estate
Bills Receivable
Revenue

4. Would you consider it proper to include as an asset the following items? Why?

Insurance premium unearned
Taxes paid in advance
Advertising expenses

CHAPTER VII

THE TRIAL BALANCE

1. Introductory

We have seen that when books are kept on the double-entry system each transaction requires debits and credits of equal amount, although not always equal in the number of items. An entry may have several debits for one credit or vice versa; but the total amount debited must equal the total credited to all accounts affected. Consequently, the sum of the debits must equal the sum of the credits in the ledger. A quick means of ascertaining whether or not this condition of exact balance exists is necessary as a first check or verification of any bookkeeping work. The expedient known as a trial balance provides this check.

2. Methods of Preparation

A trial balance, as its name implies, is a test or trial of a double-entry ledger to see whether or not the credits equal the debits; if they do, the ledger is said to be "in balance." This is not, however, conclusive evidence that the accounts are correct. (See § 5.)

There are two common ways of taking or preparing a trial balance. One is to list the total debits and the total credits of each account, and the other is to list only the balance of each account. Under both methods the amounts shown for the various accounts are separated as to debits and credits, and the total of the debits is

compared with the total of the credits. The method of listing balances only is the more common practice; but the first method is used to some extent. Whichever method be adopted, if the total credits are not shown to be equal to the total debits, the ledger is said to be "out of balance." The amount by which one total exceeds the other is known as the "difference"; and the mistake or mistakes causing that difference should at once be ascertained.

3. Avoiding Needless Repetitions

A trial balance should be taken at least monthly—often enough to make the detection of errors comparatively easy and yet not so frequently as to become unnecessarily burdensome. For the average business a monthly trial balance is sufficient. The trial balance should be so arranged as not to necessitate the rewriting of the names of ledger accounts each month. Most accounts continue from month to month and are represented in more than one trial balance throughout a year. For example, a Furniture and Fixtures account normally appears in the trial balance each month although its balance may not vary from month to month.

4. Uses of the Trial Balance

While the principal use of a trial balance is to determine whether or not the ledger is in balance, it has a further use in supplying data for the preparation of statements. Statements are generally rendered monthly and the trial balance, if properly arranged, provides a ready means for securing most of the figures. To facilitate this work, the trial balance should list the accounts

in the order in which they are to appear on the statement, and the figures shown by the trial balance should be those required by the statement. As a general rule, statements show net figures; but the form of statement may require total figures—for example, the total charges and credits to an account such as Freight. If net figures only are needed, the trial balance should show the balances of the accounts; but if total figures are required it should show total debits and total credits in such accounts. The trial balance may be arranged so that it can be added in sections and provide subtotals which will agree with those shown on the required statements.

5. Limitations of the Trial Balance

The trial balance establishes one fact only, and that is whether or not the debits equal the credits throughout the ledger. It is evident, therefore, that there may be mistakes in the ledger which the trial balance cannot disclose. These may be either mistakes of charging or crediting a wrong account; or they may be mistakes of addition or other calculation. The latter mistakes *will* be disclosed by a trial balance unless they are of such a nature that errors on the debit side exactly offset those on the credit—a coincidence known as a "compensating" error.

Mistakes of charging or crediting a wrong account may first occur in a book of original entry. For instance, an item for repairing machinery may be charged to Machinery account instead of to Repairs, with the result that the assets of the business are overstated and the expenses understated. On the other

hand, the book of original entry may have correctly assigned the item to the proper account, but it had been posted in error to a wrong account.

Other examples are mistakes in addition or other calculations in books of original entry, or in posting, or in ledger accounts, or in the trial balance itself. Such mistakes would be disclosed by the trial balance unless they were exactly compensating. Sometimes these mistakes can be detected by a mere inspection of the figures. A person familiar with the business and its accounts might detect an abnormally large balance in one of them. Generally, however, mistakes which are not disclosed by the trial balance will be disclosed only by an audit made by some person within the business organization or by a professional auditor. The fact that a trial balance will not disclose all mistakes, some of which may be vital, makes it desirable to have the books audited by some person other than the bookkeeper in charge.

6. Illustrative Problem

The method of preparing a trial balance can be illustrated by a supposititious case. Assume that an examination of the ledger of Thomas Malen shows the following accounts with the amounts therein:

THOMAS MALEN—CAPITAL

		1919	
		Jan. 2	$10,075.00

CASH

1919		1919	
Jan. 31	$25,000.00	Jan. 31	$12,000.00

Merchandise Purchases

1919		1919	
Jan. 31	$20,000.00	Jan. 20	$200.00

Merchandise Sales

1919		1919	
Jan. 15	$100.00	Jan. 31	$15,000.00

Expenses

1919			
Jan. 2	$200.00		
7	300.00		
8	100.00		
16	50.00		
20	475.00		
28	200.00		
31	100.00		

Notes Receivable

1919		1919	
Jan. 31	$3,000.00	Jan. 15	$ 500.00
		31	1,000.00

Notes Payable

		1919	
		Jan. 15	$5,000.00
		31	6,000.00

Furniture and Fixtures

1919			
Jan. 2	$1,500.00		
10	200.00		

E. Strauss

1919		1919	
Jan. 2	$1,200.00	Jan. 12	$1,200.00
15	6,000.00	25	6,000.00
24	5,000.00	30	3,000.00

K. Otter

1919		1919	
Jan. 7	$1,400.00	Jan. 8	$200.00
9	300.00	12	800.00
		20	350.00

A. Bender

1919		1919	
Jan. 22	$2,000.00	Jan. 22	$1,500.00
		31	300.00

H. Carver

1919		1919	
Jan. 10	$3,000.00	Jan. 3	$3,000.00
20	500.00	15	4,000.00
25	700.00		
31	800.00		

M. Olson

1919		1919	
Jan. 15	$1,950.00	Jan. 10	$1,950.00

A. Lett

1919		1919	
Jan. 31	$3,000.00	Jan. 15	$5,000.00

The simple procedure of listing the balances of the foregoing accounts as shown below, with debit balances

in the first column and credit balances in the second column, produces the trial balance, the equality of the figures proving that the ledger is in balance:

THOMAS MALEN

TRIAL BALANCE

January 31, 1919

1	Thomas Malen—Capital			$10,075	00
2	Cash	$13,000	00		
3	Merchandise Purchases	19,800	00		
4	Merchandise Sales			14,900	00
5	Expenses	1,425	00		
6	Notes Receivable	1,500	00		
7	Notes Payable			11,000	00
8	Furniture and Fixtures	1,700	00		
9	E. Strauss	2,000	00		
10	K. Otter	350	00		
11	A. Bender	200	00		
12	H. Carver			2,000	00
13	A. Lett			2,000	00
		$39,975	00	$39,975	00

REVIEW QUESTIONS

1. (a) Define a trial balance.
   (b) What is shown by a trial balance?
2. (a) What is the function of a trial balance?
   (b) Do you consider its use necessary?
3. How may the accounts in a trial balance be best arranged?
4. Prepare a trial balance from the following:

Discounts to customers	$ 4,030.00
Entertainment of customers	2,000.00
Inventory of miscellaneous equipment	81,900.00
Merchandise purchases	410,000.00
Notes receivable	3,050.00

Accounts receivable	250,000.00
Insurance on equipment	1,150.00
Insurance premiums, employers' liability	4,000.00
Taxes on personal property	1,000.00
Interest, general	4,470.00
Cash	45,000.00
Labor	335,000.00
Power	21,000.00
Repairs to equipment	1,310.00
Miscellaneous expenses	3,010.00
Office pay-roll	18,000.00
Merchandise inventory, first of year	75,000.00
Merchandise sales	1,048,500.00
Allowances to customers	10,900.00
Office furniture and fixtures	5,700.00
Salaries of officers	15,000.00
Postage	2,000.00
Telegrams and telephones	1,800.00
Bank charges for collecting checks and drafts	700.00
Stationery and printing	3,050.00
Freight on purchases	23,000.00
Freight on sales	10,000.00
Cartage and express inward	3,750.00
Premiums paid for bonding office employees	250.00
Traveling expense of salesmen	17,500.00
Salesmen's commissions and salaries	40,000.00
Notes payable	99,050.00
Accounts payable	43,000.00
Proprietor's capital	243,520.00
Professional advisor's fees	1,500.00
Cartage—Out	4,300.00
Discounts allowed on our purchases	6,300.00
Returned sales from customers	41,000.00

(The trial balance footing should be $1,440,370.)

CHAPTER VIII

DETERMINATION OF PROFIT OR LOSS

1. Double-Entry Profit and Loss

The distinctive feature of double-entry bookkeeping, apart from the principle of equilibrium, is the analyzed information given concerning profits and losses. Double-entry bookkeeping is designed to record transactions in such a way that each kind of income and each kind of expense is represented by an account. It is evident that the final profit or loss can be determined by comparing the total of all expenses with the total of all income. An excess of the income total constitutes a profit, and an excess of the expense total constitutes a loss.

2. Adjusting Entries

The balances of income and expense accounts are ultimately transferred to the Capital account. Before effecting this transfer, one must know which accounts these are in order to know which balances to transfer.

At the end of any fiscal period it is almost certain that some accounts will be mixed in nature in that they are partly profit and loss and partly balance sheet. A simple example of such an account is that of insurance where a premium is paid for three years. In such a case, at the end of the first year the balance of the Insurance account includes not only the insurance expense for the year just passed, which is the nominal element,

but also an asset element consisting of the portion of the premiums prepaid which have provided insurance for two years more.

Every account should be scrutinized at the end of a fiscal period to ascertain its exact nature. If it is a mixed account, adjusting entries should be made to reduce it to a simple account, either balance sheet or profit and loss. The adjustment is most easily effected by opening a new account to which part of the balance of the mixed account can be transferred. If an account is mixed, in that it contains a balance sheet and a profit and loss element, it is obvious that the removal of one of these elements reduces the account to its simplest form by leaving in it only the other element.

3. Example of a Mixed Account

The best example of a mixed account is one with merchandise wherein both purchases and sales are recorded. In such an account the first entry would obviously relate to either purchases or an opening inventory. At that point the account is a balance sheet account because it represents simply an asset. When a sale is credited the account then becomes mixed because the sale not only reduces the asset by the cost of goods sold, but it also records the gross profit—that is to say, the excess of the selling price over the cost of what was sold. The account is therefore mixed. It represents both the cost of the goods on hand—because the cost of goods purchased has been debited to it and the credits for sales include the cost of goods sold—and also the gross profit on sales.

In the form in which the account stands, the gross

profit cannot be determined because the credits for sales do not indicate separately the gross profit and the cost of goods sold. It then becomes necessary to adjust this mixed account in order to ascertain how much of it is the nominal element of gross profit.

4. Ascertaining the Gross Profit on Merchandise

In ordinary accounting practice the gross profit is determined in the following way: First, ascertain the cost of the goods sold. This can be found by taking an inventory of the goods on hand and subtracting it from the total merchandise on hand at the beginning and purchased during the period. The inventory of merchandise on hand is, of course, a balance sheet element since it is an asset. This real element can, in effect, be subtracted from the total purchases by being credited to the Merchandise account and debited to an asset account termed "Merchandise Inventory."

By crediting Merchandise with the closing inventory, the balance sheet element has been taken out of the account and consequently only the profit and loss element remains. This profit and loss element will usually be the gross profit and is represented by a credit balance in the Merchandise account. This credit balance is then treated like the credit balance of any other profit and loss account which represents income.

5. Treatment of Other Mixed Accounts

In adjusting the Merchandise account, the real element, the merchandise on hand, is taken out of it and transferred to a new account, leaving only the element of gain which is then ready for transfer to

Profit and Loss account, as will be explained in the following section. There are, however, other mixed accounts which require different treatment. An account representing furniture and fixtures, for example, will become a mixed account with the passage of time because such an asset depreciates—that is, it will be reduced in value through use. If such an asset costs $100 and its life is estimated to be ten years, at the end of the first year the asset would be worth approximately $90, though the account which represents it still has a debit balance of $100. To adjust a mixed account of this sort, an adjusting entry is made which credits Furniture and Fixtures with $10, the depreciation for the period, and debits a new account, "Depreciation," which is purely an expense or nominal account. The nominal element is thus removed, leaving the asset account purely real. The modern practice of making the credit in such a case to a separate account known as Reserve for Depreciation, instead of directly to the asset account, will be explained in a subsequent chapter. In principle the credit can be made directly to the asset account. The effect of the entry in either case is to remove the nominal element from the account and leave the real.

From the foregoing explanation it follows that at the end of each fiscal period all accounts must be closely scrutinized to ascertain which represent income and which expense elements. When an account is found to be mixed in that it includes both profit and loss and balance sheet elements, it must be simplified by removing one or the other so that the profit and loss elements can be clearly ascertained. Such adjusting entries must pro-

vide not only for the adjustment of items already on the books as in the two foregoing illustrations, but they must also set up on the books any income or expense items applicable to the period but not yet recorded.

The most common example of such an item is that of an accrued pay-roll. When a fiscal period ends in the middle of a pay-roll week, an entry should be made debiting Wages and crediting Accrued Pay-roll for one-half of the weekly total, in order to record all wages expense applicable to the fiscal period. The same procedure is applied to income items, when, for example, a commission or fee has been earned but not yet recorded. In the latter case an entry must be made debiting the person who owes the fee and crediting an income account. After all adjusting entries have been made, the accounts will then consist of clearly defined profit and loss accounts on the one hand and balance sheet accounts on the other.

6. Closing Entries

The problem of transferring the balances of the profit and loss accounts to the Capital account has now to be considered. Simplicity in the accounts is much to be desired. Consequently a method has been devised of transferring the profit and loss balances first to a clearing house account in which the excess of the income items over the expense items, or vice versa, can be determined. The entries by which these transfers are effected are known as closing entries, and the clearing house account is known as a Profit and Loss account. Once having determined the balance of the Profit and Loss account, that amount only is transferred to the Capital

account as representing the profit or the loss, as the case may be, during the fiscal period.

A Profit and Loss account should be opened in the books only at the close of each fiscal period and only for the purpose of providing one account to which the balances of all nominal accounts can be transferred for comparison. Some bookkeepers open a Profit and Loss account during a fiscal period and charge or credit it with unusual items such as legal fees or profits on the sale of fixed assets. Such practice is not sound. Unusual items of profit or loss should be debited or credited to accounts with a descriptive title, and the Profit or Loss account should be used only as a clearing house account at the end of a fiscal period.

7. Example of Closing Entries

An example of a few simple closing entries will clarify the above description. Assume that a trial balance at December 31, 1919, contains the following balances:

Merchandise Inventory, January 1, 1919	$ 5,346.00	
Purchases	38,357.00	
Wages	6,941.00	
Rent	2,400.00	
Advertising	947.00	
Insurance	78.00	
General Expense	3,479.00	
Sales		$69,342.00

The first step in determining the profit or loss for the year is to take an inventory which in this case may be assumed to be $4,462. It will be noticed that instead of one comprehensive merchandise account, this trial

balance shows accounts kept with inventory, purchases, and sales. This segregation of like items is considered better practice because it obviates a mixed merchandise account.

The adjusting entries to determine the gross profit, which is the excess of selling price over the cost of goods sold, are made by debiting Profit and Loss with the balance of Purchases and of the opening Merchandise Inventory account ($38,357 + $5,346 = $43,703), and crediting Profit and Loss with the balance of Sales account plus the value of the closing inventory ($69,342 + $4,462 = $73,804), the excess of the credits representing the gross profit. The gross profit may thus be stated as being the excess of sales and closing inventory over beginning inventory and purchases.

The subtraction of one from the other to arrive at this gross profit is obtained by placing the items on opposite sides of the Profit and Loss account as shown below. It would not only be inconvenient to make actual subtractions on one side of the ledger account but it would be highly confusing to add certain figures in one column and subtract other figures in the same column.

The net profit is determined by deducting the expenses for the period from the gross profit. Expenses, as we have seen, are invariably debits to appropriate accounts. Therefore, these accounts are closed by debiting Profit and Loss with the amounts accumulated in the respective accounts. The following outline account will make the procedure clear, it being understood that each of the entries shown has its corresponding debit or credit in another account of the same name:

PROFIT AND LOSS

Merchandise Inventory, January 1, 1919	$ 5,346.00	Sales	$69,342.00
Purchases	38,357.00	Inventory, December 31, 1919	4,462.00
Wages	6,941.00		
Rent	2,400.00		
Advertising	947.00		
Insurance	78.00		
General Expense	3,479.00		
Net Profit	16,256.00		
	$73,804.00		$73,804.00

The balance of the above account is the net profit $16,256, which amount is credited to Capital account. Net profit, however, is not always closed into Capital in this way. If drawings have been made from profits by the proprietor for his personal use, these items should properly have been debited to a "Drawing" account. Where such an account exists, it is sometimes considered better practice to transfer the balance of Profit and Loss, if a profit, to this Drawing account so that the profit earned can be compared with the drawings, to ascertain whether or not all the profit has been withdrawn. If, on the other hand, the Profit and Loss account shows a loss, it is generally better to transfer this debit balance directly to the Capital account, to which should also be transferred the balance of the Drawing account. In this way any decrease in capital will be accounted for by showing how much has been lost in the operation of the business and how much has been withdrawn. The significance of these figures is apparent when it is realized that withdrawals are withdrawals of capital or profits and are not expenses.

8. Proof of Correctness of Profit and Loss

After all nominal accounts have been closed into Profit and Loss, which in turn has been closed into Capital, it follows that only balance sheet accounts remain open on the ledger. These will then show the assets, liabilities, and capital of the business in the same way that they showed these facts at the beginning of the fiscal period. A proof of the correctness of the Profit and Loss account can be secured by comparing the capital at the end of the fiscal period with that at the beginning.

The changes in the capital through the fiscal period may have been due to contributions of capital, withdrawals of capital, and to a profit or loss. If all these elements are correctly recorded in drawing and nominal accounts, and if these accounts have been correctly transferred to Capital account, the ledger should be in balance at the end of the fiscal period after the closing entries have been made. The increase or decrease in capital during the period, that is to say, the change in the balance of capital from the beginning of the period to the end of the period, must be exactly accounted for by contributions and withdrawals on the part of the proprietor and by the balance of the Profit and Loss account transferred to Capital.

REVIEW QUESTIONS

1. What is the purpose of financial statements?
2. Why cannot a standard form be given for the profit and loss statement?

3. What adjustments of the ledger accounts are necessary to form financial statements?
4. (a) Criticize the Merchandise account as ordinarily kept.
   (b) Suggest a remedy.
5. How is profit and loss determined from a set of books?
6. State the process of closing a ledger.

CHAPTER IX

STATEMENT OF TRADING AND PROFIT AND LOSS

1. Function of Statement of Profit and Loss

The function of a statement of profit and loss is to set forth the earnings and expenses of a business, both from its operation and from outside investments and sources. Earnings may be defined briefly as increases in capital not due to contributions by proprietors; and expenses may be defined as decreases in capital not due to withdrawals by proprietors. The statement of profit and loss should show all the earnings and expenses so arranged and classified as to disclose clearly the net result of the fiscal period. It should show them in such a way that the management of the business may be aided in its work of increasing the net profits during succeeding periods. This chapter will be devoted to a discussion of the presentation of such a statement in adequate form, but it should be borne in mind that no standard form is fixed either by law or by usage. The requirements of each case should be separately considered. The preparation of a form that will present adequately a complicated statement of facts is sometimes a difficult matter.

2. Trial Balance Before Closing

We have seen that the process of closing the books means transferring the balances in all nominal profit

and loss accounts to the Profit and Loss account, the balance of which is carried to the Capital account either directly or by the way of a Drawing account. As an aid to the understanding of the statement presented in this chapter, the preclosing trial balance is shown below and the closing entries are briefly summarized:

CHARLES TOMPKINS

TRIAL BALANCE BEFORE CLOSING

December 31, 1919

	Dr.	*Cr.*
Cash	$ 4,567.00	
Accounts Receivable	16,627.00	
Merchandise Inventory, Jan. 1, 1919	5,346.00	
Investments	6,000.00	
Furniture and Fixtures	3,000.00	
Accounts Payable		$17,327.00
Charles Tompkins, Capital		5,129.00
Charles Tompkins, Drawings	4,421.00	
Sales		69,342.00
Returned Sales	113.00	
Purchases	38,357.00	
Returned Purchases		479.00
Discount on Sales	798.00	
Discount on Purchases		692.00
Interest on Investments		400.00
Wages	6,941.00	
Rent	2,400.00	
Advertising	947.00	
Freight Inward	195.00	
Freight Outward	100.00	
Insurance	78.00	
General Expense	3,479.00	
	$93,369.00	$93,369.00

The bookkeeping involved in recording some of the transactions summarized in the above trial balance has not yet been discussed and will be taken up later. A knowledge, however, of the procedure is not necessary to understand the purpose and content of a profit and loss statement. The point to note in the foregoing trial balance is that assets and expenses appear on the debit side, liabilities and capital on the credit side, and that the items "Returned Sales" and "Discount on Sales" are debits, and "Returned Purchases" and "Discount on Purchases," are credits, because they are deductions from, or offsets to, Sales and Purchases accounts respectively. A deduction or subtraction from an account, as we have seen, is made by entry on the opposite side from which transactions in such an account normally appear. With this explanation the procedure in preparing closing entries and drawing up a profit and loss statement can now be discussed.

3. Preparation of Closing Entries

After the trial balance has been taken off, closing entries should be prepared to transfer the balances of all nominal accounts to the Profit and Loss account. The balance of the latter account should then be transferred to the Capital account.

The first step in preparing these closing entries is to record the inventory at December 31, 1919, which in this case is assumed to be $4,462. In ordinary books of account such as those kept by trading concerns, the amount of the closing inventory is not disclosed by the accounts but must be determined either by counting the actual stock or by estimate. Since this closing inven-

tory is the amount of merchandise purchased but still remaining on hand, the inventory should be valued at purchase or cost price because the amount of it must be deducted from the purchases in order to determine the cost of the merchandise sold. Conservative practice, for reasons to be explained in a later volume, demands that the inventory be valued at purchase or market price, using the lower of the two.

The closing entries for the illustrative example are not given in detail because they do not differ from the usual form explained in the preceding chapter.

4. Incorrect Statement

The correct method of presenting in the form of a profit and loss statement the data shown in the above trial balance can be made clearer by its presentation first in an obviously faulty form for the purpose of criticism and discussion. Statements as incorrect as the one shown below are frequently found by accountants in public practice. The correct form of such a statement will be given later and by comparing the correct with the incorrect method when reading the text, a clear conception will be gained of its proper form and arrangement.

CHARLES TOMPKINS

STATEMENT OF INCOME AND EXPENDITURE

December 31, 1919

Income:	
Sales, Gross	$69,342.00
Closing Inventory	4,462.00
Returned Purchases	479.00

Discount on Purchases	692.00	
Interest on Investments	400.00	$75,375.00
Expenditure:		
Purchases, Gross	$38,357.00	
Returned Sales	113.00	
Opening Inventory	5,346.00	
Discount on Sales	798.00	
Wages of Employees	6,941.00	
Rent	2,400.00	
Advertising	947.00	
Insurance	78.00	
Freight and Cartage-In	195.00	
Freight and Cartage-Out	100.00	
General Expense	3,479.00	58,754.00
Final Profit		$16,621.00

5. Title of Statement

The title as shown above, "Statement of Income and Expenditure, December 31, 1919," is incorrect in several particulars, principally with regard to the date. This kind of statement, unlike a balance sheet, is designed to show the results of operation of the business during a period of time, and consequently the period should be designated. In the title above only one date is given, which would reasonably be taken to be the ending date, although it is not so specified. The period should be described either by stating the length of time, for example, one year ended December 31, 1919—or by specifying both the beginning and the ending dates. It will be assumed that this statement covered the year ended December 31, 1919.

Another error in the title of the statement is the use

of the word "expenditure." This is obviously due to a confusion between the words "expenditure" and "expense," which are not synonymous, although frequently so used. An expenditure is a payment or an obligation to pay for something and it may or may not be an expense, depending upon the nature of the services or thing acquired by the expenditure; for example, a payment or obligation to pay for a fixed or permanent asset is called a capital expenditure and is not an expense. On the other hand, an expenditure for wages is called a revenue expenditure and does result in an expense. If this kind of title is to be used it should be stated as "Income and Expense."

There is considerable difference of opinion as to the proper title. Some persons prefer to use the term "Income, Profit and Loss," others prefer "Profit and Loss," while in certain classes of business the form is "Revenue and Expense," and in still others, the statement would be entitled "Income Statement." Possibly the most exact title for a statement such as the one under discussion is "Statement of Income and Profit and Loss," and this title is used in the amended statement shown in § 15. It is selected because certain items appear on the statement which do not result strictly from the operation of the business, such as interest on investments, an income rather than a profit.

6. Form of Statement

The statement is presented in what is known as the running or statement form. Another form widely used shows expenses on the left and income on the right side, with a balance of profit and loss, as the case may

require, inserted to make the totals of the two sides equal. This, known as the account form, is not to be recommended for general use. It is somewhat technical and less easily understood than the running form in which the income items are placed first and the expenses deducted from them, leaving the net profit or loss, as the case may require, shown at the bottom.

Frequently a profit and loss statement is described as a "Profit and Loss Account." Care should be taken to ascertain whether the term refers to a transcript of the Profit and Loss account as it appears in the ledger, or to a statement of profit and loss prepared from the ledger. The latter assumption would be correct if there were no definite indication that the former kind of statement was intended. This confusion is due to a loose use of "account," which is not a statement, but a collection in a ledger of the debits and credits concerning a specified property, person, income, or expense.

On the statement as amended in § 15, the items are grouped in the endeavor to give the utmost information to a person untrained in bookkeeping or the use of accounting statements. A fundamental rule in statement preparation is that figures should be so clearly arranged that any person of ordinary intelligence can understand them. A further rule is to show the results of the various operations when this is possible.

7. Deductions from Sales

Listed among the expenses is an item for returned sales amounting to $113. This is not an expense but a cancellation of sales due to returns by customers of merchandise which the sellers were willing to receive in

cancellation of the buyer's obligation. In order, therefore, to state the actual sales it is necessary to deduct the returns from the gross sales; this has been done on the corrected statement, the net sales shown as $69,229.

Some accountants prefer to deduct also the freight and cartage-out on the theory that the selling price, which, of course, was credited to sales, included a charge for freight either expressly stated or included as an increase of selling price. It is probably not the general practice to deduct freight and cartage-out, and it should not be done unless the facts clearly show that the cost of such freight was really included in some way in the selling price charged to the customers and credited to sales.

Sometimes the discount on sales is deducted from the total sales in order to determine the net sales, but this would rarely be correct, as explained below.

8. Cost of Goods Sold

In order to determine the gross profit it is necessary to deduct from the sales the cost of the goods sold, and this cost is determined, as shown on the corrected form of statement in § 15, by adding the purchases to the beginning inventory and deducting the closing inventory from the total. In the preparation of this part of the statement three items require particular mention.

The returned purchases of $479 are deducted from the gross purchases of $38,357, leaving the net $37,878, as shown in the corrected statement. These returned purchases are similar to returned sales and therefore are deducted from the gross in order to ascertain the real or net amount of purchases.

Freight and cartage-in are added with the purchases to the beginning inventory because the figure desired is the cost of procuring the merchandise to be sold. One element of such cost is the expense of getting it to the place of sale. If the seller of the merchandise prepays the freight and charges the firm for the cost of the merchandise together with the freight, the firm does not keep an account for the inward freight, but charges the Purchases account with the amount of the invoice, which includes the freight. When, however, the firm as buyer pays such freight it keeps account of it, but this freight should not be regarded as an expense. It really is a part of the merchandise purchases account. Although kept separate for bookkeeping reasons, these two accounts are combined in the preparation of a statement of profit and loss for determination of the cost of procuring merchandise for sale.

The discount on purchases of $692 is not deducted from the gross purchases for the same reasons that discount on sales is not deducted from sales. These accounts will be discussed in a later paragraph.

The total cost of goods sold, as shown by the corrected statement, is $38,957, which is subtracted from the net sales of $69,229 to give the gross profit of $30,272.

9. Expenses

Where the expenses of selling have been kept in sufficient detail it is advisable to show them in a separate section under such a caption as "Selling Expenses." When this is done, the deduction of selling expenses from gross profit leaves what is usually designated as

"Net Profit on Sales." In the case under discussion only two items relate strictly to selling, namely, advertising and freight and cartage-out. Where the items are so few, listing them in a separate section tends to make the statement unnecessarily complicated. Hence, in the amended statement, these selling expenses are grouped with the general or administrative expenses under the caption of "Expenses."

10. Prepayments

Among the expenses listed in the statement are advertising, rent, and insurance. Insurance is usually paid in advance for one or more years; rent frequently is paid in advance, particularly when payable quarterly; and advertising is sometimes undertaken on a large scale involving heavy initial outlay, from which the business will profit in subsequent years. In any of these cases it would be inexact to charge the total of these payments as expenses applicable to the current year. Consequently, the portion really applicable to the current year is ascertained in the most practicable manner, and that portion only should be stated as expense, the balance being carried in the balance sheet as a "deferred" charge, i.e., a sort of temporary asset, which will be decreased as the value of the service prepaid is consumed. In the case under discussion there is nothing to indicate that any part of these expenses is applicable to subsequent years; consequently the full amounts stand as expense of the current year.

When the general expense is large, some explanation should be given to show what items have been included therein. An analysis stating separately each

principal kind of expense included in it is usually the most convenient form of explanation. Many bookkeepers are prone to charge to general expense any unusual item which cannot readily be classified, regardless of its nature and amount. Such procedure obscures the accounts. When large or unusual items of expense are incurred they should not be "buried" in general expense but should be shown separately on the statement.

11. Capital Income and Expense

Frequently both expenses and income do not result directly from trading or selling but are incidental to the operation of the business as is shown in the case under discussion by the discounts on purchases and sales. These are assumed to be cash discounts or allowances for the payment of bills prior to their actual due dates. They do not reduce the purchase or selling prices of merchandise, but are allowances or rebates to induce prompt payment. While it is true that cash discounts on sales are generally beyond the control of the seller, since he cannot foretell which of his customers will take advantage of them, nevertheless such discounts are of the same nature as those on purchases which the firm itself takes. Consequently, it is reasonable to subtract one kind of discount from the other and to show on the statement the excess as an income or expense. Since such items relate to the securing of capital, they may properly be listed as "Capital Income and Expense."

As is explained in Chapter XXV of this volume, cash discounts should not be confused with trade discounts. The latter are deductions from catalogue or

list prices merely to fix the selling or purchase price of an article. When once determined this is the only price which appears on the bill or invoice; consequently trade discount ordinarily does not show in the accounts of either the seller or the buyer. Trade discounts are employed to obviate the reprinting of catalogues or price lists whenever the market price fluctuates, and also to provide a means of making special prices to customers who are to be favored because of large purchases, good credit, or other considerations.

12. Other Income

After the net profit on the operation of the business has been determined, interest on investments must be considered. As these investments are not necessary in the conduct of the business, the income derived from them is not an earning of the business and is therefore shown separately on the statement. The total of such income and the net profit on operation is the net income.

13. Net Income Credited to Capital Account

On the statement presented for criticism the net income credited to capital is designated as "Final Profit." That term is not explicit. In the statement as corrected it is "Net Income Credited to Capital Account."

14. Closing Drawing Accounts

Sometimes drawing accounts are closed directly into the Capital account. But, as already explained, another method is to credit profits to the Drawing account and then to close the balance of the latter into the Capital account. This has the advantage of showing

in the Drawing account how much profit can be withdrawn without impairing the capital and also the amount actually withdrawn. It thus becomes apparent whether or not capital has been decreased. If drawings do not equal profits, the Drawing account will have a credit balance which really represents profits left in the business and therefore constitutes an increase in capital.

If, however, there has been a loss, the loss together with any drawings should be charged directly to the Capital account. The reason for this distinction is that if the loss be charged to a Drawing account and then the total of that account be transferred to Capital, the latter will not indicate separately the amount of drawings and the amount of the loss.

15. Corrected Statement

The various changes explained above are illustrated in the following example:

CHARLES TOMPKINS

STATEMENT OF INCOME AND PROFIT AND LOSS

For the Year Ended December 31, 1919

Sales:		
Gross	$69,342.00	
Less Returned Sales	113.00	
Net Sales		$69,229.00
Cost of Goods Sold:		
Inventory, January 1, 1919	$5,346.00	
Purchases	$38,357.00	
Less Returned Purchases	479.00	37,878.00

Freight and Cartage-In	195.00	
	$43,419.00	
Less Inventory, December, 31, 1919.	4,462.00	
Total Cost of Goods Sold		38,957.00
Gross Profit		$30,272.00
Expense:		
Advertising	$ 947.00	
Freight and Cartage-Out	100.00	
Wages of Employees	6,941.00	
Rent	2,400.00	
General Expense	3,479.00	
Insurance	78.00	
Total		13,945.00
Net Profit on Sales		$16,327.00
Capital Income and Expense:		
Discount on Sales	$798.00	
Less Discount on Purchases	692.00	106.00
Net Profit on Operations		$16,221.00
Other Income:		
Interest on Investments		400.00
Net Income for Period Credited to Capital Account		$16,621.00

16. Balance Sheet

After the closing entries have been made, the financial condition of Charles Tompkins can be indicated by the following balance sheet:

CHARLES TOMPKINS

BALANCE SHEET

December 31, 1919

Assets

Cash	$ 4,567.00
Accounts Receivable	16,627.00
Merchandise Inventory	4,462.00
Investments	6,000.00
Furniture and Fixtures	3,000.00
	$34,656.00

Liabilities and Capital

Accounts Payable	$17,327.00
Charles Tompkins, Capital	17,329.00
	$34,656.00

REVIEW QUESTIONS

1. Prepare a statement of trading, and profit and loss from the trial balance as prepared in answer to Question 4 of Chapter VII. In this connection, take into consideration the inventory on December 31, end of year, which amounts to $90,000.
2. Take a trial balance of the accounts left on the ledger after the profit and loss accounts have been closed out, and the net profit transferred to capital. (This trial balance acts as test of the accuracy of the profit as determined. From it the balance sheet will be prepared as explained in Chapter XI.)

CHAPTER X

STATEMENT OF CASH RECEIPTS AND PAYMENTS

1. Use of Cash Statements

A statement of cash receipts and payments is useful in presenting an analysis of the cash transactions which are stated in summary form in the cash account in the ledger. These transactions are itemized in the cash book, as explained in Chapter XVII, but there they are recorded chronologically and thus the receipts and payments are not classified by sources and purposes. Such classification is essential for administrative control in order to test the integrity of the cashiers and also to forecast the probable receipts and payments of succeeding periods.

Sometimes an attempt is made to use a statement of cash receipts and payments to indicate the profit or loss of the business. Profit or loss, however, cannot be indicated even with approximate accuracy by a cash statement, as will appear from the following discussion. This limitation of the statement of cash receipts and payments is not as generally understood as it should be; hence, this chapter presents and discusses a typical cash statement, pointing out its legimate uses and the reasons why it does not disclose the profit or loss of the business. This chapter should be carefully read in the light of the discussion in Chapter IX to which frequent reference should be made.

2. Form and Content

A statement of cash receipts and payments should show the balance of cash on hand at the beginning of a period, the amounts of cash received and paid during the period, and the balance of cash on hand at the end of the period. The form of such a statement and the amount of detail which it should disclose are matters of judgment. Sometimes the double or account form is used, showing the beginning balance and the receipts upon the left side and the payments and closing balance on the right. Again, the running form of statement is used in which the opening balance is shown first, followed by the receipts; from the total of these two classes of items the payments are deducted, and thus the closing balance is left at the bottom. This closing balance should agree with the cash balance displayed in the balance sheet as of the closing date. Whenever a supporting schedule is used, care must be exercised to make sure that the final figure shown by the schedule agrees with the balance sheet figure which the schedule is intended to amplify or explain (see Chapter XIV).

The second or running form of cash statement is generally preferred. This form is more easily read than the first one, because it is not necessary to compare figures which are opposite each other as they are in the account form. It is easier to read down a page than to read opposite pages at the same time.

3. Illustrative Statement

The following is an example of a statement of cash receipts and payments. The discussion presented in this chapter will be based upon this statement.

ALEXANDER BISHOP

STATEMENT OF CASH RECEIPTS AND PAYMENTS

From January 1, 1918, to December 31, 1918

Balance in hand and on deposit, January 1, 1918....		$12,417.82
Receipts:		
Accounts Receivable.....	$42,863.27	
Cash Sales.....	491.83	
Interest on Bonds Owned.....	500.00	
Dividends on Stocks Owned.....	1,250.00	
Interest on Bank Balance.....	111.42	
Refunds by Creditors for Overpayment	37.19	
Sale of Office Desk.....	25.00	
Alexander Bishop—Additional Capital.	5,000.00	50,278.71
Total Available Funds.....		$62,696.53
Payments:		
Accounts Payable.....	$17,642.54	
Cash Purchases.....	872.61	
Show-Cases	2,000.00	
Wages	4,697.82	
Rent	6,000.00	
Advertising	2,462.95	
Freight Inward.....	117.89	
Freight Outward.....	96.82	
Insurance	378.95	
General Expense.....	2,637.41	
Interest on Bank Loan.....	180.00	
Alexander Bishop—Drawings.....	4,735.29	41,822.28
Balance in hand and on deposit, December 31, 1918..		$20,874.25

4. Title of Statement

There is some difference of opinion as to the proper title for a cash statement. Frequently it is termed "Statement of Cash Receipts and Expenditures." This

is not an exact description because the word "expenditures" means more than the word "payments." An expenditure is a payment or an obligation to pay for something and therefore the word includes more than payments alone. Incidentally, the word "expenditure" ought not to be used in a statement of profit and loss to take the place of the word "expense." Expenditures, it should be remembered, are of two kinds. They include not only "revenue expenditures," which constitute expense, but also "capital expenditures," which result in the acquisition of fixed assets, and which therefore are not to be classified as expense.

Frequently in cash statements the word "disbursements" will be used. The word "payment" is preferable, partly because it is shorter and partly because of a slight difference of meaning. As defined by the dictionary, a payment is "an act of paying, or that which is paid; the discharge of a debt or obligation." The dictionary definition of disbursement is "money expended, especially from public funds."

5. Dates of Statement

Both the beginning and ending dates are specified in the above statement. This clearly defines the period covered. It would not be sufficient to give only the ending date because then the length of the period would not be disclosed. Another manner of dating, which in some cases is satisfactory, is to designate the period covered and to specify only the ending date; for example, the above statement might be entitled, "For the Year Ended December 31, 1918." When, however, a cash statement covers a period of time less easily designated

than one year, as, for example, an odd number of months, it is better to mention both the beginning and the ending date in order to fix definitely the beginning date. Statements should be so prepared as to obviate all avoidable mental effort on the part of persons using them.

6. Details on Statement

The balances at the beginning and the end are described as "in hand and on deposit." As a rule it is unnecessary to specify how much of the balance is on deposit in banks or which banks hold the deposits and how much is on hand in a petty cash or other fund. When such information is important, the best way to show it, if there are not more than four or five banks and funds, is to indent an itemized list of the various items and to extend the total as the balance in hand and on deposit. If there are more than four or five, it is advisable to state the balance as follows: "Balance in Hand and on Deposit, January 1, 1918, per Schedule." A schedule should then be attached to the statement showing in detail the location of all the cash balances composing the total amount at the date specified.

On a cash statement the receipts and the payments should be indented so as to show the total of each. It is important to give full information as to actual receipts and payments during the period covered, from which an estimate can be made as to probable receipts and payments during a succeeding similar period. A proprietor in his eagerness to make a profit should not overlook the equally important task of providing funds with which to meet current obligations.

7. Arrangement of Items

To facilitate the use of the statements, the detailed items specified under receipts and payments should be arranged in some logical order. Circumstances must govern the determination of the order to be used in each case, but once an order is adopted, both receipts and payments should be listed according to the same plan. Items are arranged sometimes in the order of their amounts; at other times according to the source of receipts and kind of payments; or, they may be arranged alphabetically. An established form should be adhered to in subsequent statements unless there is good reason to change it; every variation in the form of statements which are successively prepared makes comparisons more difficult. Statements should be so designed that items of one year can be compared quickly with similar items in any preceding year.

The form of the statement shown above has sometimes been criticized because the total of the opening balance and the receipts is stated as "Total Available Funds," whereas this total was never wholly available at any one time. The criticism seems unimportant. Some title should be given to the total as a matter of form if for no other reason; it does not seem a misnomer to use "Total Available Funds," since these funds represent a total out of which payments were made, although that total was never wholly in hand at any one time.

8. Accounts Receivable

Collections from accounts receivable do not necessarily represent income during the period because a large part of the collections may be on bills rendered for

goods sold at an earlier date; on the other hand, at the end of the period there may be outstanding accounts receivable which have resulted from sales made during the period.

When a sale is made, the excess of the selling price over the cost of the goods sold is known as gross profit and this gross profit is an income earned at the time of the sale. If the sale is on credit, an account receivable is created for the amount due from the customer; but the collection of that account has no effect on the gross profit. Any income from gross profit is earned at the time of the sale and not when an account receivable is collected. Thus the total income during a fiscal period from gross profits is the excess of selling prices of all merchandise sold over the cost of such merchandise, regardless of whether the sales were made for cash or on credit and regardless of the collections during the period from customers on charge sales.

9. Cash Sales

The receipts from cash sales represent income for the period, provided all the sales were made and collected within the period. If, however, it were the practice to include C. O. D. sales in this classification, there might be uncollected shipments at the end of the period or collections on prior shipments. With that exception, receipts from cash sales represent the income from that source.

10. Interest on Bonds Owned

Cash received as bond interest represents bond income only if the bond interest periods coincide exactly

with the fiscal periods of the business and if the bond coupons are collected on the day they become due. This is rarely the case. Bond income really accrues from day to day, although it can be collected only on fixed dates. Consequently bond income is the coupon rate of interest on par value calculated for the fiscal period regardless of when the coupons are actually collected. Further, the coupon rate of interest would not be the true rate of income if the bonds were bought at a premium or at a discount. (See Volume IV.)

11. Dividends on Stocks Owned

Cash received from dividends constitutes income only if the dividends are paid within the same fiscal period in which they are declared. Dividends, unlike interest, do not accrue from day to day. They should be considered for the period in which they are declared, because at that time the corporation becomes indebted to the stockholder for the amount of the dividend, the latter acquiring, by such declaration, an account receivable. The collection of a dividend does not affect the income of the stockholder; it is merely the conversion of an account receivable into cash.

12. Interest on Bank Balance

Interest on a bank balance accrues from day to day and is subject to the same comments as interest on bonds, except for the feature of premium or discount which may be involved in the latter. However, if the interest is on a savings bank account, a distinction exists. As a rule savings banks do not pay interest, in the strict sense of the term; they declare dividends at the end of each

half year. The fact that such dividends are usually at a fixed rates does not change their nature. Consequently dividends, or so-called interest, on savings bank accounts should be considered income as of the date on which they are declared, which date may or may not fall within the same fiscal period as the day on which they are paid.

13. Refunds by Creditors for Overpayments

Refunds by creditors for overpayments do not constitute income at all. Such items are reductions in cash payments made on accounts payable. While necessary in a statement of cash receipts and payments, these items would not be included in a statement of profit and loss.

14. Sale of Office Desk

Cash received for the sale of a fixed or permanent asset at its book value does not affect income in any way, because there is merely the conversion of a fixed asset into a current asset, without the slightest change in the capital. If the sales price is lower than its book value, a loss is incurred; if higher, an income is earned. Such losses and incomes would not be disclosed, however, by the mere statement of the cash received on the sales.

15. Alexander Bishop—Additional Capital

This receipt of cash has increased the business capital; but it does not constitute income because it is not due to the operations of the business. It is necessary information to be placed in a cash statement, but it would have no place in a profit and loss statement which would show only income and expense items.

16. Accounts Payable

The item of accounts payable is subject to comments similar to those made upon accounts receivable. Accounts payable do not necessarily represent expense of the business during the period under attention. Moreover, inasmuch as some of the accounts payable may be capital expenditures, payments to creditors may not represent expense at all.

17. Cash Purchases

The item of cash purchases represents expense for merchandise purchases only if the payments are made within the period in which the goods are received and taken into the inventory.

18. Show-Case

In the purchase of a show-case there was merely the conversion of a current asset, cash, into a fixed or permanent asset, fixtures. No expense resulted because the capital was not decreased by the transaction.

19. Wages and Other Expenses

Payments for expenses do not represent the true amount of the expense for the period, except in the rare case where no expenses were accrued either at the beginning or at the end of the period. The time covered by wage payments seldom terminates on the day when payment is made. Rent is frequently paid in advance, in which event the payment does not represent the expense of rent, but creates an asset known as prepaid expense. The same is true of advertising if a certain part of it clearly benefits subsequent periods; and the same is true

also of insurance if premiums are paid for more than the current fiscal period.

20. Alexander Bishop—Drawings

Drawings by the proprietor do not constitute an expense of the business, although a nominal or arbitrary sum drawn by him is sometimes considered salary. The amount of the so-called salary is any amount determined by the proprietor, and the fact that none of it is payable if no profits are earned is evidence that it is not really salary—but is a withdrawal of profits.

21. Items Not Disclosed

A statement of cash receipts and payments will not disclose changes in inventory. A statement of cash receipts and payments does not disclose depreciation charges. Depreciation continues regardless of the amount of repairs and renewals or up-keep which may or may not have been paid for in cash, and the amount thereof should be taken up in the accounts to ascertain the total business expenses.

22. Conclusion

The conclusion is inevitable that the inflow and outflow of cash does not measure the profit or loss of a business. It does not take into consideration income not collected and expenses not paid; it omits certain items such as inventory fluctuations, which very positively affect the earnings of the business. A statement of cash receipts and payments would approximate the profit or loss of a business run strictly upon a cash basis if the inventory remained constant and if there were no sub-

stantial depreciation. However, this combination of circumstances is exceedingly rare.

A cash statement is of value in enabling administrative officers to form judgments as to financial policies. The average inflow and outgo of cash during previous periods indicates in a general way the amount of money which will be available for current liabilities during succeeding periods. The essential point is, however, that while the cash statement has its uses, it does not disclose the profit or loss of a business. The use of cash statements for that purpose is now confined chiefly to clubs, churches, fraternal societies, and very small businesses, although until recently insurance companies made such use of them and until more recently cities and other governmental bodies did likewise.

REVIEW QUESTIONS

1. Define expense, disbursement, expenditure, payment.
2. Differentiate between a statement of income and expense and a statement of receipts and payments.
3. When, if ever, does a statement of receipts and payments contain the same information as a statement of income and expense? Discuss fully.
4. What administrative value has a statement of cash receipts and payments?

CHAPTER XI

THE BALANCE SHEET

1. Definition and Purpose

A balance sheet is a statement of assets, liabilities, and capital (or deficit) as of a specified moment of time, prepared from double-entry accounts. Where the accounts have not been kept by double entry, the term "balance sheet" ought not to be applied to a statement of financial condition because a *balance* or equilibrium of the accounts does not exist. In the latter case, the statement should be so entitled as to indicate the fact that it is not based on double-entry accounts. It may be termed, for example, a "statement of financial condition" or a "statement of assets, liabilities, and capital."

The purpose of the balance sheet is to display the financial condition of the business at the time specified, so that the relation between current assets and current liabilities and between fixed assets and fixed liabilities will be apparent. The balance sheet is one of the two fundamental accounting statements and it meets the first requirement of account-keeping, namely, that the financial condition of the business be disclosed. The other fundamental statement is that showing the profit or loss and accounting for changes in financial condition (exclusive of those due to additions or withdrawals of capital). Other statements are frequently used but it will be found in almost every case that they merely support or explain figures in the two fundamental statements.

2. Two Forms of Arrangement

A balance sheet may be arranged either in statement form, with the assets appearing first, followed by the liabilities and capital; or in account form, with the assets on the left and the liabilities and capital on the right side. Although the arrangement of assets and liabilities on opposite sides of the balance sheet may be designated as the "account form," it is not correct to speak of the left or asset side as the "debit side," and the right or liability side as the "credit side." A balance sheet has neither debit nor credit side. It is simply a statement of the assets, liabilities, and capital of a business at a particular moment of time, and its arrangement may vary according to the ideas of the compiler.

When the number of items are few, it is advisable to use the statement form, so that the entire balance sheet may be shown on a sheet of paper, say, 8½ inches wide. The account form of a balance sheet requires paper twice as wide as the statement form.

Assets and liabilities should be so arranged as to convey the clearest and fullest meaning possible and this can usually be best accomplished by employing one of the two forms of arrangement shown below. While both methods are in common use, the second form should be employed when compiling a statement of financial condition for credit purposes. For such purposes, the quick, or liquid assets (those most readily convertible into cash) are usually more significant than the fixed assets (those not readily convertible into cash and the value of which does not fluctuate on account of business operations). A credit

man when estimating the risk involved in an application for credit will often disregard the fixed assets while carefully scrutinizing the amounts of all quick assets and quick liabilities, and also the difference between their total amounts. This examination is made to ascertain the amount of available or working capital, which may be defined as the excess of current assets over current liabilities.

3. Arrangement No. 1

BALANCE SHEET

December 31, 1919

Assets	*Liabilities and Capital*
1. Show all tangible fixed assets in the order of the size of their amounts.	1. Show all fixed liabilities in the order of the size of their amounts.
2. Show all intangible fixed assets, in the order stated above.	2. Show all current liabilities in the order in which they are ordinarily liquidated.
3. Show all quick assets in the order of their availability to a going business.	3. Show capital in proper detail.
4. Show all items of deferred charges to profit and loss in the order of their amounts, the largest amount being shown first.	

4. Arrangement No. 2

BALANCE SHEET

December 31, 1919

Assets

1. Show all quick assets in the order of their availability to a going business.
2. Show all tangible fixed assets in the order of their money values, the largest amounts appearing first.
3. Show all intangible fixed assets, in the order stated above.

4. Show all items of deferred charges to profit and loss in the order of their amounts.

Liabilities and Capital

1. Show all current liabilities in the order of their liquidation, with the most pressing items shown first.
2. Show all fixed liabilities according to their importance, and monetary size; or in the order of their permanency.
3. Show capital in proper detail.

5. Deferred Charges to Profit and Loss

This is a general term which covers any expense charged but not absorbed by the operations of the business during the present fiscal period, e.g., insurance premiums paid in advance, interest paid in advance, advertising paid in advance, or office supplies not exhausted.

6. Showing of Deficit

Deficit, if it exists, may be shown in the same position on the balance sheet as capital, but as a red ink figure, in which case it should be deducted from the total amount of liabilities in order to bring the footings of the two sides, or parts, of the balance sheet in agreement. Deficit is sometimes placed on the asset side of the balance sheet, but although shown in this position it is obviously not an asset.

7. Showing of Liabilities

The word "Liabilities" is frequently shown as a heading on the right-hand side of the balance sheet. This would be quite proper if all the items on the right-hand side were liabilities, but this is not the case. Capi-

tal, as already explained, is the excess of assets over liabilities, and is included on the liability side of the balance sheet so as to make the footing of that side agree with the footing of the asset side. Thus a more exact heading is "Liabilities and Capital."

8. The Nature of Capital

Capital, whether the business be that of a corporation, partnership, or individual, is an accountability resting upon or assumed by the business, and the business becomes custodian of the capital thus invested. It is not a liability, because the business is not obliged to pay it at any time. Those who invest the capital cannot demand that it be returned to them as they could in the case of an ordinary liability before the liquidation of the business. In the case of liquidation all creditors must first be satisfied before the proprietors are allowed to participate in the amount realized by the assets. After all liabilities are satisfied, the residue belongs to the proprietors.

9. Contingent Liabilities

Contingent liabilities are amounts which will become payable by the business only in case certain contingencies materialize, e.g., notes receivable discounted (see Chapter XXVII), accommodation indorsements, etc. Such liabilities should be clearly shown on the balance sheet by means of footnotes in which their nature is briefly described, or by other equally clear means to be described later. If such liabilities are not shown on the balance sheet they might be overlooked and in that event the business might not be prepared to meet them.

10. Incorrect Form of a Balance Sheet

No hard and fast rules can be laid down as to the arrangement of items in a balance sheet or any other financial statement. The opinions of competent accountants differ concerning many points of arrangement and technique. The suggestions made in this and other chapters are not intended to be dogmatic or arbitrary; their purpose rather is to indicate how ambiguities can be avoided and statements made simple and intelligible.

Since much can be learned by the study of a form which is faulty and the comparison of it with a correct form, two balance sheets are presented in this chapter—the first to illustrate a number of errors and the second to show the statement in its corrected form. A criticism of the incorrect balance sheet point by point will be helpful.

A. JENKINS

BALANCE SHEET

For Year Ended December 31, 1919

Assets

Notes Receivable		$ 750.00
Real Estate	$30,000.00	
Less Mortgage	14,000.00	16,000.00
Cash		7,436.00
Factory Buildings		22,000.00
Accounts Receivable		16,478.00
Machinery and Tools		4,500.00
Inventory (at 133 1/3% of cost)		8,920.00
		$76,084.00

Liabilities

Accounts Payable	$28,639.00
Notes Payable	16,000.00
A. Jenkins, Capital	31,445.00
	$76,084.00

11. Date of Balance Sheet

The date of this balance sheet is stated "for the year ended December 31, 1919." This is incorrect because a balance sheet is a statement of assets, liabilities, and capital (or deficit) at some specified date, showing the condition of a business at a particular moment of time, that is, at the close of business on a particular day. If the condition as at the close of business on December 31, 1919, is to be stated, the balance sheet should be dated "December 31, 1919," and not in such a way as to imply that the condition stated prevailed during a period of time such as "for the year ended."

12. Arrangement of Items

Balance sheets, in common with all other financial statements, should be prepared in an orderly way. The items should be arranged in some logical order so that they can be easily read and understood. Both assets and liabilities on this balance sheet are listed indiscriminately. Accounting authorities are not in agreement as to the order to be followed, but all agree that some definite order should be maintained in the listing of both assets and liabilities. One plan is to list them in the order of time in which they will probably be converted into cash or paid; another plan is to adopt exactly the

reverse arrangement. In practice the plan which will arrange the items in their order of interest to the user of the statement is the one to be adopted.

Generally speaking, a balance sheet of a sole proprietor should list the assets and liabilities in the first order named. This is because the items of most interest are the current assets and liabilities or those which are actively handled by the business. In the corrected balance sheet given in § 17, the assets and liabilities are listed with the current items first in the probable order of their conversion into cash or liquidation by payment.

13. Inventory Valuation

In the foregoing balance sheet the inventory is shown valued at 133 1/3% of cost, which represents its estimated selling price, the gross profit of 33 1/3% having been calculated on cost. It is incorrect to carry an inventory at valuation exceeding its cost for the following reasons: There can be no profit on merchandise until it has been sold and yet, if merchandise is carried as an asset at more than its cost, the effect is to show that a profit has already been earned. This follows from the fact that if the asset "inventory" is increased above its cost, some other account must be credited with that increase, and since no liability account is affected the increase must be credited as a profit. The item of inventory ought, therefore, to be reduced to 100% of cost. 133 1/3% equals 4/3, and since 4/3 amounts to $8,920, 1/3 will equal $\frac{1}{4}$ of this amount, or $2,230, and 3/3, or 100% of the cost, will be three times this amount, or $6,690. The latter amount is the proper valuation.

14. Working Capital

The current assets as shown by the revised balance sheet consist of:

Cash	$ 7,436.00
Notes Receivable	750.00
Accounts Receivable	16,478.00
Inventory	6,690.00
	$31,354.00

The current liabilities on the other hand are:

Notes Payable	$16,000.00
Accounts Payable	28,639.00
	$44,639.00

It thus appears that the current assets would be insufficient to meet the current liabilities by $13,285.

Under these circumstances the business cannot be said to have any working capital. Working capital should be clearly indicated on a balance sheet and this can be done only by grouping the items so that current assets can be compared with current liabilities.

15. Real Estate Mortgage

In the balance sheet as given, the real estate mortgage is deducted from the Real Estate account, only the equity in the property being carried as an asset. Many accounting authorities approve of this procedure; some of them in all cases, and others only if the property when acquired is subject to a mortgage without assumption of the mortgage debt by the present owner. This view is logical and if the mortgage on the real estate is

purely a right against the property and if there is no personal liability on the mortgage debt, the deduction of the mortgage from the real estate serves the useful purpose of indicating the present value of the equity.

However, even on the assumption that there is no present liability on the mortgage, if the real estate was acquired for a fixed asset, it is unlikely that the present owner would permit the mortgagee to foreclose. Consequently, it seems better to list the real estate at its cost plus the mortgage debt, and to include the mortgage among the liabilities, even though the mortgage debt may not have been incurred by the present owner or assumed by him.

16. Facts versus Opinion

Many statements in the balance sheet under discussion are assumed to be matters of fact, whereas they are, in reality, matters of opinion. The assets, cash and notes receivable, may fairly be said to be statements of fact in that there is a balance in the bank and currency in the office which equal the asset of cash and definite notes equal to the amount carried in the balance sheet for notes receivable. On the other hand, certain of the assets are given an estimated value; machinery and tools, buildings, even real estate itself, are really listed at figures which represent only opinion as to their worth. Moreover, the amount at which accounts receivable are carried is purely a matter of opinion because there is no way of knowing whether or not they are actually worth the figure given. That figure may include actual losses already incurred from bad debts.

On the liability side accounts payable and notes pay-

able are statements of fact. The amount of capital is largely a matter of opinion because the profits or losses which have changed it from its original amount are based on estimates both as to income and possible losses.

17. Corrected Balance Sheet

After the various changes explained above are made, the balance sheet would appear in the following form:

A. JENKINS
BALANCE SHEET
December 31, 1919

Assets

Current Assets:		
Cash	$ 7,436.00	
Notes Receivable	750.00	
Accounts Receivable	16,478.00	
Inventory	6,690.00	$31,354.00
Fixed Assets:		
Machinery and Tools	$ 4,500.00	
Factory Buildings	22,000.00	
Real Estate	30,000.00	56,500.00
		$87,854.00

Liabilities and Capital

Current Liabilities:		
Notes Payable	$16,000.00	
Accounts Payable	28,639.00	$44,639.00
Fixed Liabilities:		
Real Estate Mortgage		14,000.00
Capital		29,215.00
		$87,854.00

18. Balance Sheet and Post-Closing Trial Balance

As explained in Chapter VII, a trial balance is "taken off" prior to making the adjusting and closing entries necessary for the determination of the profit or loss of the business. Such entries eliminate the nominal accounts by transferring their balances to the Capital account via the Profit and Loss account. After that elimination has been accomplished, only real and personal accounts remain open upon the ledger. At that point another trial balance should be taken in order to ascertain that no clerical errors were made in the process of "closing" the accounts. The new trial balance is known as the post-closing trial balance because it is made after the closing of the nominal accounts.

The post-closing trial balance obviously can disclose only assets, liabilities, and capital because only real and personal accounts remain open on the ledger. This trial balance, however, usually does not obviate the preparation of a balance sheet for the following reasons:

(a) The trial balance lists the accounts in the order in which they are found on the ledger, and this order is not generally the one best adapted for presentation of the items in a balance sheet.

(b) The trial balance does not show group- or sub-totals for current assets, fixed assets, current liabilities, and the like; such sub-totals are essential in the balance sheet in order to facilitate the determination of working capital and other vital facts.

(c) The trial balance states each balance as debit or credit, whereas in the balance sheet it

sometimes is desirable to deduct certain debit balances from credit balances, or vice versa, in order to show clearly the most significant figures.

Thus, although the post-closing trial balance contains all the figures needed for a balance sheet, the latter statement should be prepared to present these figures in the form designed to be most intelligible to the persons who require the information to be conveyed.

REVIEW QUESTIONS

1. What is a balance sheet?
2. In what order should the several items in a balance sheet be placed? Give reasons.
3. What are the principal differences between a trial balance taken before the books are closed and one taken directly after they are closed? How does the latter differ from a balance sheet?
4. Is the trial balance essential to the making of the balance sheet, and if so, why? And if not, why not?
5. Distinguish between the function of a profit and loss statement and that of a balance sheet.

CHAPTER XII

STATEMENT OF AFFAIRS

1. Balance Sheet Information

The successful administration of any business requires two kinds of information—one concerning the profits and losses made during a period of time and the other showing the financial condition at a particular moment of time. This chapter is concerned with the latter kind of information when a business is about to dissolve or to pass through either voluntary or involuntary reorganization.

The financial condition of a solvent, going concern is shown in the balance sheet as described in Chapter XI. Therein the fixed assets are valued at cost less a reasonable depreciation regardless of their present market price, and inventories of merchandise are valued at cost or market price, whichever is lower. The liabilities are listed on a balance sheet at their full amounts regardless of any securities held by individual creditors or of any preferences which may entitle some creditors to priority in payment. The balance sheet shows merely the total assets and the total liabilities, not indicating in any way how such assets would be applied to the payment of liabilities in the event of insolvency.

2. Solvency and Insolvency

The term "insolvency" is sometimes used vaguely, without a clear comprehension of its meaning. The word

must be defined in order to understand the exact function of statements prepared to show the degree of insolvency.

The assets of a business may exceed its liabilities and yet it may be unable to pay its creditors promptly. Ready money may have been invested in fixed assets in such amounts that the current liabilities cannot be met as they mature. From one point of view such a business is regarded as insolvent. A business may be insolvent also from another viewpoint. It may be able to pay its current obligations for the present and, with reasonable certainty, for the immediate future, and yet the fact may be obvious that within a short time it will become unable to do so because its assets will have been exhausted. In that case the business is insolvent because its liabilities exceed its assets although it is able for the present to meet current obligations.

3. Inadequacy of Balance Sheet for Insolvents

In either case, when a business is insolvent it becomes necessary to secure more capital, to reorganize by a change of personnel, or to dissolve entirely. Whatever the remedy, the persons vitally interested are the creditors and the proprietors. The financial condition of the business must be so displayed that both sets of persons interested can clearly see what the outcome of the reorganization or the dissolution is likely to be. Of the two, the creditors are to be considered first because under the law no proprietor is entitled to take precedence over any creditor in the distribution of the assets of an insolvent business.

A balance sheet falls short of being an adequate presentation of the financial condition of an insolvent busi-

ness for the following reasons. In the first place the assets are not to be continued in use by the business but are to be sold at whatever can be procured for them. On a forced sale, assets produce much less than their book value, at which a going concern is entitled to carry them. Thus a balance sheet will not disclose what the business may reasonably expect to realize on its assets. In the second place, a balance sheet does not indicate whether or not any of the assets are held as security by any of the creditors, nor does it indicate whether any particular creditors must be paid before other creditors.

4. Statement of Affairs

From the foregoing presentation of the inadequacy of a balance sheet when a business is insolvent and is about to dissolve, it becomes apparent that a special form of statement must be prepared to set out the facts of insolvency. This, known as a statement of affairs, is so arranged as to show, first, the assets at both their book value and at the valuation which they may reasonably be expected to realize at forced sale; then, the liabilities in the order in which they must be paid, if any such order exists; and finally, what part of the assets have legally been pledged to secure payment of particular liabilities, thus disclosing the net value of assets estimated to be available for the payment of unsecured creditors. The form of such a statement is immaterial provided it discloses the three kinds of information enumerated. It will be found in practice, however, that the form suggested in § 9 conveniently meets these conditions and therefore should be adopted in ordinary cases of insolvency.

5. Rules for Valuing and Stating Assets

Assets should be shown in a statement of affairs in some logical arrangement, preference being given to a listing of current assets first. Three money columns should be used. In the first of these the book values at which the assets have been carried on the accounts of the business should be shown; in the second column should be indicated the probable amounts to be realized upon the forced sale of such assets; and in the third, the differences between the book values and such anticipated amounts. As a general rule, a substantial shrinkage in asset value may be expected. The amount of this shrinkage constitutes that part of the deficit due to the loss in asset value upon forced sale.

To estimate the amount that may be realized upon a forced sale is a difficult problem. The amount must be fixed with two considerations in view. It must not be overstated because that would lead to unwarranted expectations on the part of creditors who might rely upon such a statement in effecting a settlement of their claims with the business. On the other hand, it must not be understated because that would tend to relieve the person who conducts the sale from the obligation to secure the highest possible price. The liquidator should be spurred on to secure the highest possible price and he should not be given any excuse for selling at a lower price.

The reason for stating the book value of the assets is to provide a means of checking or comparing the statement of affairs with the balance sheet in order to determine that all the assets have been listed. If their total book value as shown by the statement of affairs

agrees with the total as indicated on the balance sheet, a ready verification of the former statement can be made.

6. Rules for Stating Liabilities

The liabilities should be listed in the same general order used in the stating of assets, and for each liability should be noted both its book value and the amount which will have to be paid from the general assets of the business.

Those liabilities which are secured will not be paid out of the general assets. A secured liability is one for which the creditor holds assets of the business previously given to him in accordance with law as security for his claim, which assets are salable by him under conditions of law in case the business fails to meet the liability. Secured creditors naturally will utilize for their reimbursement such assets as they hold as security. Consequently secured liabilities are noted in the first column of the statement of affairs as being book liabilities; but their amounts are not extended into the second column because they do not constitute claims to be met out of the general assets.

In the same way liabilities entitled to preference, such as those for wages and taxes, should be listed as book liabilities but not stated in the "Expected to Rank" column. Their amounts should be deducted from the total assets in order to express in the statement the fact that the first available assets will be utilized in the payment of such preferred claims. Attention is called to the handling of these items in the example of a statement of affairs given below.

7. Example of a Balance Sheet

In the following balance sheet the current assets are insufficient by $16,531 to meet the current liabilities. The current assets consisting of cash and other items which in the ordinary course of business will be converted into cash amount to $28,108, whereas the current liabilities are $44,639.

This balance sheet thus presents one condition of insolvency, namely, the inability to meet current liabilities as they mature. Assuming that the business of the Jenkins Company is to be reorganized and new capital procured, the first step should be the preparation of a statement of affairs of the company. The balance sheet shown below will be converted into such a statement.

THE JENKINS COMPANY

BALANCE SHEET

December 31, 1919

Assets

Fixed Assets:			
Real Estate		$30,000.00	
Factory Buildings	$22,000.00		
Less Reserve for Depreciation	2,000.00	20.000.00	
Machinery and Tools	$ 4,500.00		
Less Reserve for Depreciation	900.00	3,600.00	$53,600.00
Current Assets:			
Inventory		$ 6,690.00	
Accounts Receivable	$16,478.00		
Less Reserve for Bad Debts	3,246.00	13,232.00	
Notes Receivable		750.00	
Cash		7,436.00	28,108.00
Total Assets			$81,708.00

Liabilities

Fixed Liabilities and Capital:			
Capital Stock Issued	$32,000.00		
Less Treasury Stock	18,000.00		
Capital Stock Outstanding		$14,000.00	
Real Estate Mortgage		14,000.00	$28,000.00
Current Liabilities:			
Accounts Payable		$28,639.00	
Notes Payable		16,000.00	44,639.00
Surplus:			
Surplus Available for Dividends		$ 4,069.00	
Reserve for Additions and Extensions of Plant		5,000.00	9,069.00
Total Liabilities			$81,708.00

8. Information Required for Statement of Affairs

In order to prepare a statement of affairs from the above balance sheet certain information not disclosed therein is needed. One must ascertain the realizable value of the assets; which of them, if any, have been pledged to creditors; and what liabilities, if any, are preferred. Assume that the following facts are to be taken into consideration. The real estate and buildings which are covered by the mortgage are estimated to be worth just enough to satisfy the mortgage debt. The machinery and tools are appraised to produce $2,500. The inventory is estimated at $4,000, and the accounts receivable are grouped into three classes as follows: good accounts $8,000, doubtful accounts $2,000, and the balance worthless. The doubtful accounts are estimated to be worth 50 per cent. The notes receivable are considered good but the cash balance includes personal I. O. U.'s of $250 which are not expected to be collecti-

ble. The accounts payable include an accrued pay-roll of $450 and taxes of $1,600. One of the notes payable for $5,000 is secured by an assignment of $6,000 of good accounts receivable.

9. Example of Statement of Affairs

With this information as a guide the balance sheet may now be converted into a statement of affairs. Such a statement is here shown and the comments which follow explain the steps by which it has been prepared.

THE JENKINS COMPANY

STATEMENT OF AFFAIRS

December 31, 1919

Assets

Book Value			Expected to Realize	Deficiency
	Real Estate	$30,000.00		
	Factory Buildings	22,000.00		
	Total	$52,000.00		
	Deduct—Reserve for Depreciation	2,000.00		
$50,000.00	Book Value	$50,000.00		
	Deduct—Mortgage, contra.	14,000.00		$36,000.00
3,600.00	Machinery and Tools		$2,500.00	1,100.00
6,690.00	Inventory		4,000.00	2,690.00
8,000.00	Accounts Receivable Good...	$ 8,000.00		
	Deduct—Loan, contra.....	5,000.00	3,000.00	
2,000.00	Accounts Receivable Doubtful.....		1,000.00	1,000.00
	Accounts Receivable Worthless	$ 6,478.00		
3,232.00	Deduct—Reserve for Bad Debts	3,246,00		3,232.00

Book Value		Expected to Realize	Deficiency
750.00	Notes Receivable	750.00	
7,436.00	Cash	7,186.00	250.00
$81,708.00	....Total per contra.		$44,272.00

Total Amount Expected to Realize...		$18,436.00
Deduct—Preferred Claims, contra:		
Wages	$ 450.00	
Taxes	1,600.00	2,050.00
Net free assets available for dividend of approximately 43% to unsecured creditors		$16,386.00
Deficiency		21,203.00
Unsecured Creditors, contra		$37,589.00

Liabilities

Book Value			Expected to Rank
$14,000.00	Real Estate Mortgage, deducted contra.		
26,589.00	Accounts Payable		$26,589.00
16,000.00	Notes Payable	$16,000.00	
	Deduct—Note Secured, per contra	5,000.00	11,000.00
450.00	Wages Payable, deducted contra.		
1,600.00	Taxes Payable, deducted contra.		
$58,639.00	Total		$37,589.00
	Capital Obligations:		
14,000.00	Capital Stock		
9,069.00	Surplus		
$81,708.00	....Total per contra.		

10. Comments on Statement of Affairs

The totals of the book value columns are equal and agree with the totals shown in the balance sheet. This

agreement is secured as regards the liabilities by including the capital obligations, although of course they will not rank as liabilities. It is desirable to have these columns in agreement with the balance sheet figures to indicate that no assets or liabilities have been overlooked in the preparation of the statement.

The reserves for depreciation and bad debts have been deducted from the values of the assets as they appear in the ledger in order to determine the book values at which they are listed on the statement. This is advisable because the reserve for depreciation is really a suspended credit which could logically have been made in the asset account but which for bookkeeping convenience was placed in a separate account. Such a reserve account has been called a "valuation account" because it reduces the value of the asset to which it applies.* By showing the real asset value as the book value, any shrinkage prior to realization upon the forced sale is eliminated so that the deficiency as it appears on the statement of affairs represents the shrinkage due solely to the forced sale. This deficiency should not be inflated by stating the book value as higher than the company itself considered the real value of the asset to be.

The liability on the mortgage of $14,000 is deducted from the real estate and buildings out of which the mortgage is to be paid. Thus the mortgage does not appear in the "Expected to Rank" column of the liabilities; and as the real estate and buildings are considered just sufficient to satisfy the mortgage, they are not listed in the "Expected to Realize" column of the assets.

*For a complete discussion of the underlying theory, see Volume IV.

The note payable of $5,000 secured by the pledge of accounts receivable is similarly treated. As accounts receivable to the amount of $6,000 are pledged to secure this note, the total surplus of $3,000 of "Accounts Receivable Good" is entered in the "Expected to Realize" column.

The statement shows that $18,436 is expected to be realized from all the assets including those which are held as security by creditors. This $18,436 must, however, be reduced by the preferred claims consisting of wages and taxes, which total $2,050. Since these preferred claims must be paid at once, the cash available for creditors will be reduced by their amount. This deduction leaves $16,386 available for unsecured creditors whose claims amount to $37,589, as appears from the "Expected to Rank" column of the liabilities. Each creditor may therefore expect to receive a dividend of about 43% of his claim and this information is clearly disclosed by the statement.

In order to bring the total of the "Expected to Realize" column into agreement with that of the "Expected to Rank" column, the deficiency of $21,203 is entered under the net free assets. This deficiency does not agree with the total of the deficiency column of the assets which is $44,272. The reason for this lack of agreement is that while there is a real deficiency or shrinkage in asset value of $44,272, this shrinkage is not wholly borne by the creditors. The capital obligations amount to $23,069, consisting of the capital stock and the surplus. As none of the assets can be applied to the reimbursement of stockholders until all creditors have been paid, it follows that the former will receive

nothing because there is not sufficient to pay the creditors. Therefore the stockholders must suffer a loss of their entire investment of $23,069. Their loss together with that of the creditors, namely, $21,203, makes the total deficiency due to shrinkage in asset value of $44,272.

11. Deficiency Account

It is customary to supplement a statement of affairs with a schedule showing how the deficiency has been caused. Such a statement is sometimes given in ledger account form. The losses due to shrinkage on each asset are listed on the debit side and are offset on the credit side by the capital obligations, which represent the losses by stockholders, and by the deficiency borne by the creditors. In this form, the deficiency account for the above statement of affairs would be as follows:

Loss on Real Estate and Buildings	$36,000.00	Capital Stock	$14,000.00
Loss on Machinery and Tools	1,100.00	Surplus	9,069.00
Loss on Inventory	2,690.00	Deficiency per Statement of Affairs	21,203.00
Loss on Accounts Receivable	4,232.00		
Loss on I. O. U.'s	250.00		
Total	$44,272.00	Total	$44,272.00

The same information can usually be displayed more simply by listing the losses in detail and then deducting from the total that part of the loss to be borne by the stockholders, namely, the amount of the capital obligations. This will leave as a balance the amount to be

borne by unsecured creditors—in the case under discussion, the deficiency of $21,203.

The forms to be selected for a statement of affairs and a deficiency account should be such as are likely to be the most intelligible to the persons who are to use them. No arbitrary forms are required by usage but those given above are frequently adopted.

CHAPTER XIII

REALIZATION AND LIQUIDATION STATEMENT

1. Duties of a Liquidator

When a business must be dissolved for the benefit of creditors, it is customary to appoint a receiver, assignee, or liquidator for the purpose of selling the assets, paying the creditors, and distributing any remaining cash to the former proprietors. Such a liquidator may be appointed by agreement between the insolvent and the creditors in a proceeding known as a friendly assignment for the benefit of creditors. The liquidator, on the other hand, may be appointed by a court to which creditors have appealed. The liquidator in the latter case is usually called a receiver or a trustee and the proceedings are usually known as involuntary, since the insolvent did not voluntarily enter into them. Whatever the method of appointment, and whatever the title of the liquidator, his duties are in the main to secure possession of all assets; to reduce them to cash by collection or sale; to apply the cash to the payment of creditors, turning any remaining cash or unrealized assets over to the former proprietors; and finally to report all his transactions to the persons who, or to the court which appointed him. Even though the liquidation be under the cognizance of a court, the preparation of the liquidator's final statement is an accounting matter, requiring at times considerable technical skill.

2. Statements by Liquidator

The first statement which a liquidator should prepare is a balance sheet disclosing the condition of the insolvent business as shown by its books. The next step is to convert the balance sheet into a statement of affairs showing the probable outcome of the liquidation, as explained in Chapter XII. After the liquidation has been completed the liquidator should prepare a report, the conventional form for which, so far as the figures are concerned, is known as a "Realization and Liquidation Statement." This statement sometimes is called an "account," but it should be borne in mind that rarely is it necessary or advisable to have one ledger account to cover all the transactions of the liquidator. The statement discussed in this chapter is one prepared by the liquidator of the Jenkins Company, thus following the same chain of transactions considered in the preceding chapter.

3. Form of Statement

The form of statement used herein is the conventional one. While not required by usage or by law, it is so convenient that it should be thoroughly understood. The purposes of the statement are to show what assets were received to be realized and what became of them; what liabilities were to be liquidated and how that was accomplished; what the expenses of the proceeding have been and what was the net outcome.

4. Additional Information Required

Since the statement of realization and liquidation is a report showing the liquidator's transactions, it is

necessary to know those transactions before the report can be prepared.

For the purpose of supplying material for this statement, the following facts are assumed. Upon foreclosure sale of the real estate and buildings under the mortgage $17,000 was realized. The machinery and tools sold for $1,000. The inventory was taken over by a creditor at a valuation of $3,000. The accounts receivable considered good produced the full amount, those considered doubtful produced $1,500, and on those considered bad $240 was collected. The notes receivable were collected and the cash was found to be in agreement with the books except for the I.O.U.'s of $250 which proved to be worthless. The liquidator was allowed $900 to cover his fee and the expenses of liquidation. He paid the wages and taxes and a dividend of 35% to the unsecured creditors and then prepared the realization and liquidation statement.

5. Illustrative Statement

An illustrative realization and liquidation statement is given on the opposite page.

6. Comments on Realization and Liquidation Statement

The following comments should be carefully considered in connection with the statement itself so that the reason for the form of presentation and the source of all the figures therein will be clearly understood.

The statement will be found upon examination to show the profit and loss upon realization. It reveals a gain of $340 which is a reduction of the deficiency of

REALIZATION AND LIQUIDATION STATEMENT

Assets to be Realized:		
Real Estate and Buildings....	$14,000.00	
Machinery and Tools.....	2,500.00	
Inventory	4,000.00	
Accounts Receivable Good.....	8,000.00	
Accounts Receivable Doubtful.	1,000.00	
Notes Receivable	750.00	
Cash	7,186.00	$37,436.00
Liabilities Liquidated:		
Real Estate Mortgage.....	$14,000.00	
Wages Payable	450.00	
Taxes Payable	1,600.00	
Notes Payable	5,000.00	
35% Dividend to Unsecured Creditors	13,156.00	34,206.00
Supplementary Debits:		
Expenses and Fee of Receiver.....		900.00
Liabilities Unliquidated:		
Accounts Payable (65%).....	$17,283.00	
Notes Payable (65%).....	7,150.00	24,433.00
Gain on Realization.....		340.00
		$97,315.00

Liabilities to be Liquidated:		
Real Estate Mortgage.....	$14,000.00	
Accounts Payable	26,589.00	
Wages Payable	450.00	
Taxes Payable	1,600.00	
Notes Payable	16,000.00	$58,639.00
Assets Realized:		
Real Estate and Buildings....	$17,000.00	
Machinery and Tools.....	1,000.00	
Inventory	3,000.00	
Accounts Receivable Good.....	8,000.00	
Accounts Receivable Doubtful.	1,500.00	
Notes Receivable	750.00	
Cash	7,186.00	38,436.00
Supplementary Credits:		
Accounts Receivable Bad, Collected.....		240.00
		$97,315.00

$44,272 shown by the deficiency account described in connection with the statement of affairs in Chapter XII.

In order to render a complete report of the receiver's administration, a cash account and a receiver's balance sheet at the close of the liquidation should also be prepared. These are shown in succeeding sections.

7. Assets to be Realized

This is a list of assets as they appear on the statement of affairs at their "expected to realize" values, including assets pledged as security for liabilities. The receiver is assumed to have realized the value of pledged assets and to have applied that value in settlement of the secured liabilities.

As a matter of fact, secured creditors would ordinarily collect their claims from the security which they hold, remitting to the receiver only any excess realized over their claims. If a secured creditor proves to be only partially secured, he would present a claim to the receiver for the deficit on his account; to the extent of that deficit he would become an unsecured creditor and be entitled to share in the dividends paid to such creditors. Thus the real estate and buildings are included among the assets to be realized; although if their valuation was the only amount realized, the liquidator would receive nothing, because that sum would be retained by the mortgagee. It is desirable, however, to include these pledged assets among the assets to be realized so that the realization and liquidation statement will be clearly shown to be complete.

The values at which the assets to be realized are listed in the present statement are those at which they

appear in the statement of affairs, the basis of valuation being for a "gone" instead of a "going" concern.

Cash is included among the assets. This procedure might be criticized upon the ground that realizing assets means converting them into cash and therefore cash received by the liquidator is already "realized." It is better, however, to include it in order to make the list of assets complete. The credit side of the statement shows that the cash is listed there as an asset realized; thus the entry for cash has no effect upon the profit or loss resulting from the liquidation.

The total of the assets to be realized is $37,436; the section entitled "Assets Realized" on the credit side of the statement shows that $38,436 was secured for them. In other words, the assets have realized $1,000 more than the receiver expected. The details composing this increase are discussed below in § 9.

8. Liabilities to be Liquidated

These items are listed at the beginning of the statement in order to show the deficiency of $21,203 at the time the liquidator takes control. In this statement all liabilities are listed. None are deducted from assets as in the statement of affairs because each liability must be paid. The liabilities to be liquidated as listed on the present statement equal the book value of the liabilities as they appear on the statement of affairs.

9. Assets Realized

As the liquidator realizes cash on the sale or the collection of assets he will charge his cash account as shown later and will credit the account for the asset

which is realized. The result of this realization will be noted in the realization and liquidation statement under the caption "Assets Realized." Each asset listed must be accounted for, either as actually realized or as unrealizable. In the latter event the asset should be noted in a section on the right-hand side of the statement entitled "Assets Unrealized."

The cash of $7,186 might be listed as the first item in the assets realized section because it was realized before the liquidator received it; but it is listed at the end on the present statement because it is relatively unimportant. The cash is inserted on both sides of the statement merely to afford easy comparison between the assets as they are listed here and on the statement of affairs. An examination of the amounts realized on other assets shows that the assets had been appraised in the preparation of the statement of affairs on too conservative a basis.

10. Supplementary Credits

When an asset not listed among those to be realized unexpectedly proves of value, the credit for it should not be stated under the section entitled "Assets Realized" because to do so would disturb the comparison between appraised and realized values. Accordingly the collection of $240 on accounts receivable considered worthless is noted in a separate section entitled "Supplementary Credits."

11. Liabilities Liquidated

When the receiver pays liabilities he credits his cash account and charges that for the liability which is settled

and notes the fact of settlement on the statement under the section entitled "Liabilities Liquidated." Each liability listed must be accounted for either as liquidated or unliquidated. In the latter case, it should be entered in a separate section entitled "Liabilities Unliquidated." The present statement shows that the preferred and the secured liabilities have been paid. It shows also that a dividend of 35% has been paid to the unsecured creditors who held accounts payable to the extent of $26,589 and notes payable of $11,000. 35% of this total is $13,156 as it appears in this statement.

12. Supplementary Debits

The expenses of the liquidator and his fee for services, amounting to $900, are stated as a supplementary debit because this item is an expense not provided for in the statement of affairs. The credit to offset this charge is to the receiver's cash account.

13. Liabilities Unliquidated

In order to show the outcome of the liquidation it is necessary to carry forward the liabilities unliquidated and this is accomplished by listing them in a section so entitled. These liabilities appear in the receiver's balance sheet shown below.

14. Receiver's Cash Account and Balance Sheet

A complete report of the receiver's administration should include a cash account and a balance sheet. The cash account contains a record of the cash received and paid out by the receiver. It will start with the balance on hand at the time he took charge; it will be debited

RECEIVER'S CASH ACCOUNT

Cash Balance		$ 7,186.00	Mortgage on Real Estate	$14,000.00
Sale of Real Estate and Buildings		17,000.00	Wages	450.00
Sale of Machinery and Tools		1,000.00	Taxes	1,600.00
Sale of Inventory		3,000.00	Notes Payable	5,000.00
Accounts Receivable:			Expense and Fee of Receiver	900.00
Good	$ 8,000.00		35% Dividend to Creditors	13,156.00
Doubtful	1,500.00			
Bad	240.00	9,740.00		$35,106.00
			Balance	3,570.00
Notes Receivable		750.00		
		$38,676.00		$38,676.00
Balance		$ 3,570.00		

RECEIVER'S BALANCE SHEET

Cash	$ 3,570.00	Accounts Payable	$17,283.00	
Deficiency	34,863.00	Notes Payable	7,150.00	$24,433.00
		Capital and Surplus:		
		Beginning	$23,069.00	
		Profit on Realization	340.00	
			$23,409.00	
		Loss of Surplus	9,409.00	
		Capital Stock Outstanding		14,000.00
	$38,433.00			$38,433.00

with the proceeds of the assets realized and with any income received by him during realization; it will be credited with the amount of the liabilities liquidated and with any expenses paid during realization.

The receiver's balance sheet should show the financial condition of the insolvent business at the date of the accounting although the liquidation may not have been completed. It should state the cash and other assets on hand, the liabilities unliquidated, and the profit or loss to the date of the accounting.

CHAPTER XIV

THE USE OF SUPPORTING SCHEDULES

1. Interpretative Presentation

The object of all statement preparation is an intelligible presentation of significant financial and operative facts. A statement is inadequate and its information is not properly presented if the user of it is not reasonably able to understand it. Significant facts are not truly presented unless they are so stated that they stand out distinct from facts which are not significant. Thus, the preparation of an adequate balance sheet, statement of profit and loss, or other accounting exhibit involves much more than a mere presentation of figures. It requires an interpretative presentation—one that can be understood by the persons for whose information it is drawn up and one that clearly invites attention to all facts which are really significant.

A statement may be true and yet not interpretative. For example, if the net profits of a business for the years from 1914 to 1918, both inclusive, were respectively $10,000, $8,000, $7,000, $6,000, and $4,000, a statement that the average net profits during the period of five years were $7,000 would be true, but it would not present the significant fact that the profits had been steadily decreasing. Further, a statement may be true but so lengthy or complex that the significant facts are obscured. To illustrate, a balance sheet may list the assets and liabilities in complete detail, without grouping

or classification, and thus obscure the fact of an insufficiency or even a complete lack of working capital.

2. Fundamental Principle of Presentation

The fundamental principle of interpretative presentation is that conclusions in concise summaries should be stated first, followed by schedules of the facts from which the conclusions have been drawn. A statement prepared in accordance with this principle discloses first in summary form all the significant facts which it is intended to convey, and then by means of supporting schedules, elaborates and amplifies the conclusions first stated. The person who reads such a statement may be contented with the summarized conclusions if the facts in outline form tell him what he wants to know; but if he wishes more detailed information he may read further and find all the figures and data upon which the conclusions are based. A busy executive or proprietor should be given the gist of the statement at once, leaving him to decide the extent of further inquiries.

For example, a balance sheet even when its items are combined, grouped, and classified, may be long and complex. In that event, its reading and study are materially assisted by a preface which may be in narrative or statement form summarizing the principal facts noted thereon. Such a preface might take the following form:

From the balance sheet, Exhibit A, it appears that the assets amount to.....	$601,982.47
Deducting from this total, the liabilities of.....	162,412.78
Leaves a capital investment of.....	$439,569.69

3. Method of Presentation

When statements take the form of summaries and supporting schedules, their use is greatly facilitated by a proper system of identification through the use of letters and numbers. To be of the most value, the system should be logical and uniformly applied. Principal statements may be designated as "Exhibits," statements supporting exhibits as "Schedules," supporting details for schedules as "Statements," and finally, any supporting details for statements should be called "Sub-statements." Exhibits are usually lettered and all other statements numbered, a new series of numbers being used for each group of similar schedules, statements and sub-statements.

4. Example of Exhibits, Schedules, and Supporting Statements

The application of this method to a complicated corporate balance sheet and statement of profit and loss may be illustrated by the following list which covers the statements most commonly prepared for the information of the management of a large organization:

Exhibit A. Balance Sheet, December 31, 1918:

Schedule 1. Notes Receivable
2. Accounts Receivable
2. Statement 1—Doubtful Accounts Receivable
3. Merchandise Inventories
3. Statement 1—Merchandise in Hands of Consignees
4. Investments
4. Statement 1—Tax-Free Investments
5. Accounts Payable
6. Surplus Adjustments

EXHIBIT B. STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED DECEMBER 31, 1918:

Schedule 1. Sales, by Departments
1. Statement 1—Chemical Department Sales, by Products
1. Statement 1—Sub-statement 1—Sulphuric Acid Sales, by Territories
2. Cost of Goods Sold, by Departments
3. General Expense

The system of identification proposed above, like many other matters of accounting procedure, is subject to differences of opinion among accountants. This necessarily follows from the fact that the preparation of statements which picture financial conditions and results is more of an art than a science and no hard and fast rules can govern all cases. In the illustration used above, some accountants might show surplus adjustments as Exhibit C instead of presenting them as a schedule supporting the balance of surplus appearing on the balance sheet, Exhibit A. Other accountants might deviate from the suggested method in not differentiating between schedules and statements; or in numbering consecutively all supporting schedules and statements, in which case Exhibit B, Schedule 1, Statement 2, would become Schedule or Statement 13. The choice of methods in each case is a matter requiring accounting judgment.

The content of each exhibit, schedule, or statement is a matter of judgment and the general principle and method outlined may be applied by individual accountants with varying results. The following sections call attention to certain matters which should be considered in preparing supporting schedules.

5. Schedule of Notes Receivable or Payable

One of the most important facts to be brought out in a schedule of notes receivable or notes payable is the amount maturing each month. Obviously, the expected receipts and payments on account of notes are factors to be considered in providing the requisite working capital. Thus, the schedule of notes may conveniently group them by maturity dates. When notes receivable have been discounted, the contingent liability, which is discussed in Chapter XXVII, may properly be noted on the schedule of notes receivable. This can be accomplished by listing in a separate group all unmatured notes which have been discounted. Notes from or to proprietors, officers, or employees should not be combined with those from customers or to creditors, banks, and other persons outside the business organization. Therefore, a schedule listing notes receivable or payable would ordinarily contain no reference to notes received from or given to proprietors, officers, or employees because such notes should not be included in the totals shown on the balance sheet which the schedule supports.

6. Schedule of Accounts Receivable

In the arrangement of a schedule of accounts receivable, a wide latitude is permissible. If the accounts are numerous, an indiscriminate list, arranged in order of amounts or alphabetically would generally be of little value. Ordinarily such a schedule should be prepared only with a definite object in view. Sometimes a list by geographical groupings such as states, counties, or cities, or by geographical territories covered by branches or agents, gives valuable information and the schedule

may so group the accounts; or accounts may be stated from the credit man's viewpoint by grouping them according to their age.

Another point which may be brought out in a schedule of accounts receivable is the number of new customers and the extent of their purchases. In much the same way the schedule may indicate which accounts are normally active by grouping them according to the value of current sales compared with sales during similar periods of preceding years. Whenever a schedule of accounts receivable serves any reasonable end it should be prepared; but in the absence of a definite purpose, its preparation would be a waste of effort.

7. Schedule of Inventory

Perhaps the most important fact to be emphasized in a schedule of merchandise inventory is the relation between material and goods fit for current use and merchandise which is suitable only for sale at reduced prices or as scrap. In many cases a schedule of the inventory may be arranged to show the principal items which compose each kind or group of merchandise.

Another significant fact to be noted in connection with the inventory is the amount of merchandise out on consignment. Such goods are properly to be included in the merchandise inventory because title to them has not passed to the consignees. But possession and custody have been surrendered and the goods are not subject to the same care nor are they held under the same market conditions as are goods in the immediate possession of the owner. Hence it is of value to know what portion of the inventory is in the hands of

consignees and the schedule should make this clear. For similar reasons the schedule should indicate the location of merchandise in different warehouses when it is so distributed.

8. Schedule of Investments

The schedule of investments should first of all group separately the bonds, stocks, real estate mortgages, and any other kind of security. The amount of information to be given concerning each kind will depend, of course, upon the contemplated uses of the schedule, but the following suggestions may be of value. For bonds there should be shown the cost or the book value, the market price, and the amount, if any, of interest in default. (For a complete discussion of these points see Volume IV.) Stocks should be listed to show their cost and market values and the rate of dividends which are being received. The list of real estate and mortgages should show not only the amounts, rates, and maturities, but also the location of all property covered by the mortgages.

9. Schedule of Capital or Surplus Adjustments

The amount of capital, or capital stock and surplus in the case of a corporation, appears on the balance sheet, and in simple cases the changes in capital during the fiscal period due to profits, losses, contributions, or withdrawals can usually be indicated on the balance sheet itself. In complicated cases, however, and also where it is desired to show only the financial condition without disclosing the profits or losses or other causes for changes in capital, the balance sheet should be sup-

ported by a schedule of capital or surplus adjustments during the fiscal period. Such a schedule may conveniently take the form of a "running" statement showing first the balance of capital at the beginning of the period. Then should follow any necessary adjustments of that balance due to corrections applicable prior to the beginning of the period (see chapter on surplus adjustments in Volume IV.) Additions to capital due to profits or contributions of new capital should next be noted. From the total thus obtained the reductions in capital should be deducted. Reductions may be due to losses or withdrawals of capital. The schedule should close with the balance of capital at the end of the fiscal period as stated on the balance sheet.

10. Schedule of Sales

The schedule of sales should show all the analysis of sales required for administrative purposes. The widest latitude exists. Sales may be analyzed by departments, products, territories, salesmen, or months, or by any combination of these bases, or on any other basis which would be useful. In a comparatively small business the sales records can be so kept as to collect currently all the figures which will be needed for the schedule of sales at the end of the fiscal period. In a large business this would be impracticable because of the variety of analyses required. The best solution is the use of a tabulating machine such as that described in Volume II. By means of the machine which sorts and tabulates cards, punched currently to record all the significant facts concerning each sale, these facts can be classified and summarized with little effort in any desired way.

The schedule of sales can then be prepared to present the data obtained by the use of the machine.

11. Schedule of Cost of Goods Sold

The cost of goods sold is a most important statistical figure for use in administrative control. The calculation of the turnover (as noted in Chapter XIX) and many significant percentages are based thereon. In a manufacturing business the determination of the cost of goods sold requires a complete and practically separate accounting system, which is described in Volume III. In a mercantile or trading business the calculation of its cost is generally made in a statement prepared from the ledger accounts and such a statement makes a useful schedule to support an exhibit showing the profit and loss of the business.

In drawing up a schedule of the cost of goods sold, the salient facts to be disclosed are:

1. Inventories at the beginning of the period.
2. Purchases of goods and amount returned, if any.
3. Allowances obtained from merchandise creditors for defective goods.
4. Inward freight.
5. Inventories at the end of the fiscal period.

These figures when used as explained in Chapter IX show the cost of goods sold. This cost should be analyzed to correspond with the analysis of sales of any department or product or other unit on which it is desired to determine the gross profit. Except for the purpose of calculating gross profit, the schedule of cost of goods sold need not follow the form and arrangement of the schedule of sales.

12. Schedule of General Expenses

It is the practice of many bookkeepers to use a general expense account as a "catch-all" instead of providing more specific accounts for items which at the first glance do not seem to be chargeable to any particular expense account. This is to be deprecated, as sound accounting requires the adequate classification of accounts and the careful analysis of transactions. Given this analysis, there may still be numerous charges to general expense and if their total is considerable a schedule should be prepared to explain the content of the item, General Expense, on the statement of profit and loss. On the schedule similar charges should be grouped and suitable captions provided. For example, occasional fees paid to lawyers or accountants, and any unusual losses or expenses which are too general in their nature to be applicable to any one department or to be combined with any regular recurring expense may appear in the schedule.

13. Miscellaneous Schedules

Other schedules not enumerated herein may often be of value in special cases. For example, schedules of plant and machinery, or a schedule of production showing the kinds and quantities of goods manufactured, and another of selling expense, by territories, by salesmen, by products sold, or on any other desired plan, often furnish valuable administrative information. Frequently, also, a schedule of cash is useful. In some cases this will be merely a list of balances on deposit in banks and on hand in various funds held by agents; in others, it may be a statement of receipts and payments such

as is described in Chapter X, the purpose of which is to account for the change in the cash balance since the last preceding balance sheet. In fact, the only limit on schedule preparation is practicability. A schedule should be prepared in every case where a statement of detail would clarify an item on any exhibit or schedule, provided, of course, that the benefit to be derived from the schedule justifies the cost of preparing it.

In conclusion the fundamental principle may be restated—let concise, summarized conclusions be supported by adequate schedules so that the reader is given both a broad view of the whole situation and a knowledge of the detail facts. Only when statements are so prepared do they render full service to the busy executive and to other persons who are to use them.

REVIEW QUESTIONS

1. What purpose does the use of supporting schedules serve?
2. Under what conditions would you submit a schedule of accounts receivable to accompany a balance sheet? Would such a schedule ever be submitted without reference to a balance sheet? What useful information may be secured from a schedule of accounts receivable properly prepared?
3. What value exists in accompanying a schedule of new customers with one showing the inactive accounts?
4. What information should be disclosed by an inventory schedule? Of what value is such a schedule?
5. A cash statement bears what relation to a schedule of maturing notes?
6. Name the principal schedules that may support a statement of profit and loss.

Part III
Simple Journal Records

CHAPTER XV

THE JOURNAL

1. Insufficiency of Ledger Record

When analyzing the nature of a business transaction, the primary object in mind is to record it correctly in the proper ledger accounts. So far, the discussion has made no reference to the manner in which transactions reach the ledger. From what has been written it is possible to assume that accounts may be debited and credited direct from the original documents which furnish the data and figures to be entered in the ledger. While this procedure theoretically is possible and is all that is required to furnish correct periodical statements of financial condition and profit and loss, the ledger presents certain deficiencies as the only book of permanent record. In practice it is found safer, more convenient, and more economical of time and labor to record all transactions in a book of original entry before transferring them to the ledger. This phase of the subject will now be discussed.

2. Illustrative Problem

The deficiency of the ledger when used as the only book of permanent record can best be illustrated by example. We will assume that the following transactions took place during the week of March 24, 1919:

24. Merchandise purchased from Adam Smith on account $2,000.

25. Office salaries paid $35.
26. Merchandise sold to Henry White on account $3,000.
28. Merchandise purchased on account from Adam Smith $2,000; John Thompson & Co. $11,500; Brown & Son $1,500. Merchandise sold for cash $500.

The ledger accounts in which these entries were recorded would appear as follows:

MERCHANDISE

1919			1919		
March 24	Adam Smith...	$ 2,000.00	March 26	H. White.....	$3,000.00
28	Adam Smith...	2,000.00	28	Cash	500.00
	J. Thompson & Co.	11,500.00			
	Brown & Son..	1,500.00			

HENRY WHITE

1919		
March 26	Mdse $3,000.00	

ADAM SMITH

		1919		
		March 24	Merchandise....	$2,000.00
		28	Merchandise....	2,000.00

OFFICE SALARIES (EXPENSE)

1919		
March 25	Cash $35.00	

CASH

1919			1919		
March 28	Merchandise.....	$500.00	March 25	Office Salaries.....	$35.00

J. THOMPSON & Co.

1919	
March 28 Merchandise...	$11,500.00

BROWN & SON

1919	
March 28 Merchandise....	$1,500.00

To record business transactions directly in the ledger accounts affected as here shown would render any system of account-keeping uncertain and unsatisfactory, for reasons which may be briefly enumerated as follows:

1. In entering the debits and credits of a transaction, the debit might be recorded properly and the credit entry might be forgotten or vice versa.
2. The debit entry might be made on the credit side of the account instead of the debit side or vice versa.
3. An entry might be placed in the wrong account.
4. If transactions were entered in the first instance directly into the accounts, the records could be more readily falsified and the cash appropriated by a bookkeeper with access to the cash. All that would be necessary would be to enter fictitious amounts in the ledger accounts and such manipulations would probably remain undetected unless the amounts involved were large enough to arouse suspicion.

A bookkeeping system should reduce the possibility of errors to a minimum, should aid as much as possible in locating errors when present in the books, and should make it difficult for one to tamper with the records. Since the ultimate purpose of bookkeeping is to record business transactions correctly in proper ledger accounts, means should be provided to insure the correctness of the records and to reduce to a minimum the possibility of fraudulent practice.

3. The Function of the Journal

One means of protection is the use of a detailed record known as the "journal." The journal is a book of original entry, in which a first record of business transactions is made. Each transaction day by day is analyzed into its debit and credit elements, and these debits and credits, after entry in the journal, are later at some convenient time transferred, i.e., posted, to the proper ledger accounts. This plan provides a chronological history or diary of events and also furnishes some protection against errors due to the omission of transactions or part of the entries concerning a transaction, and, as will be explained later, against fraud. Under double-entry bookkeeping every original entry must be made in a journal of some kind to show the analysis of the transaction which it records; hence the term "journalizing" is used to express the analysis and recording of all original entries.

4. Form of the Journal

Transactions are analyzed in the journal to show the nature of the exchange and the accounts affected in

each case. This analysis involves the determination of what accounts to debit and to credit in order to show the transfer of money or money's worth, for which an equivalent transfer is made or obligation assumed. As a means of recording this analysis into debits and credits, two money columns are provided, one for items to be debited, and one for those to be credited, to accounts in the ledger.

The entries below illustrate the arrangement of the journal and the method of making entries for the transactions presented above in their account form.

March, 1919

—24—		
Merchandise	$ 2,000.00	
To Adam Smith		$2,000.00
Purchase per invoice, March 23—3/30.		
—25—		
Office Salaries	35.00	
To Cash		35.00
Office salaries paid per authorized voucher.		
—26—		
Henry White	3,000.00	
To Merchandise		3,000.00
Sales per bill rendered, March 25—3/10.		
—28—		
Cash	500.00	
To Merchandise		500.00
Sale of merchandise for cash.		

	–28–	
Merchandise	15,000,00	
To Sundries:		
Adam Smith		2,000.00
John Thompson & Co.		11,500.00
Brown & Son		1,500.00
Purchases per invoices of March 27—3/30.		

As the object of a journal entry is to record the amounts and the ledger accounts affected by each transaction involved, the names of the accounts to be debited and credited appear in the space devoted to the explanatory matter, with the debit and credit figures in the adjoining columns. To distinguish clearly the one entry from the other, the explanation of the credit item or items is usually preceded by the word "To" and written a little to the right of the explanation of the debit item or items. The comparison of the above entries with those made in the ledger account (see § 2) makes clear the method of making entries. A glance at the first journal entry, for instance, is sufficient to indicate that Merchandise account is to be debited with purchases to the value of $2,000 made from Adam Smith, and that the account of Adam Smith is to be credited with $2,000 for merchandise bought from him. The advantages are apparent of recording in one place and on the date of its occurrence all the data relating to a given transaction, which data will usually require posting to at least two and sometimes several accounts.

If the ledger were the only book of permanent record, fictitious entries might be made in its numerous pages with little chance of their attracting attention; whereas, when a complete history of each transaction

is recorded in one place on the date of its occurrence, all entries can be easily scrutinized as to their correctness. Reference to the business papers and other supporting documents on which the entries are based will, when necessary, enable anyone to verify the entries.

5. Importance of Complete Explanation

Each journal entry should be accompanied by an explanation given in such detail that its meaning will be plain at any subsequent time. Frequently journal entries are difficult both to make and to understand because of the complexity of facts to be recorded and the analytical skill required to determine which accounts should be debited and which credited. If such entries are not sufficiently explained, it becomes virtually impossible at subsequent times to understand them, when the facts upon which they are based have been forgotten. An entry should be fully explained, however obvious the information may seem at the time it is made and regardless of the space it requires. There is no objection whatever to the inclusion of a copy of a contract or any other document within the journal—pasted or copied therein—and there is no reason why an explanation should not cover an entire page or more if necessary. Explanations should, of course, be as concise as clarity permits, but they must explain.

6. The Use of "To" and "By"

In journal entries the word "To" is frequently found preceding the name of the account to be credited. If such an entry were to be stated in narrative form it would be, for example, "Merchandise debited to Adam

Smith who is credited." This could be stated in reverse order, as "Adam Smith credited by merchandise which is debited." It would, therefore, be technically correct to put the word "By" preceding the name of the account to be debited, and the word "To" preceding that to be credited, and some bookkeepers always do this. This is unnecessary, however, and in modern commercial practice both words are usually omitted.

7. Date and Amounts

Other points relating to the date and amounts should be carefully noted because each is of practical importance.

The date of entry is placed in the center of the page instead of at the left, for the purpose of showing more clearly each day's transactions. The month and year should be written at the top of each page, and whenever a new month is started a new page should be used even though there is ample space on the preceding page. The approved form of an entry is to have the debit item precede the credit, and this rule holds even though there is more than one credit for each debit or vice versa. Sometimes where a number of accounts are to be debited or credited, the word "Sundries" is used as shown on the fifth entry above.

It will be noted that the list of sundry items is not totaled. Adding the items of a journal entry is necessary only to establish the fact that the debits equal the credits. The totals should not, however, appear in the journal. Nothing of value would be obtained by adding the columns in a two-column journal if each entry is separately proved to be in balance.

8. Points to Observe in Posting

Transferring the record from the book of original entry to the ledger accounts affected, is known as "posting." After a posting has been completed, but not before, the page of the ledger on which appears the account to which the posting has been made should be noted on the book of original entry opposite the entry of the transaction posted, and then in the ledger account a similar record should be made of the page of the book of original entry from which the posting is made. The habit should be formed of entering these pages or "folios," as they are termed, only after a posting is completed, but invariably at that time. This provides a simple check on the completion of the work so that if the bookkeeper is interrupted he will know, when he resumes work, at exactly what point the interruption occurred. Many bookkeepers make a practice of entering the ledger folio in the book of original entry before posting, in the endeavor to save time by avoiding reference to the index of the ledger each time a posting is made. Such a practice is likely to cause errors and is not to be commended.

9. Rules for Journalizing

The practical value of double-entry bookkeeping consists in the security afforded as to the accuracy of the records by the use of the principle of equilibrium or the balancing of accounts. In journalizing, the bookkeeper must know exactly how to apply this principle by knowing what accounts to debit and to credit. The following rules for journalizing summarize the information so far presented and are here given for reference.

They apply to every situation, and, if referred to when the journalizing of a particular transaction is doubtful, should help to solve the difficulty.

An account having an appropriate caption should be debited to record:

1. Acquisition or increase of an asset.
2. Cancellation or reduction of a liability.
3. An expense or loss.
4. Reduction in capital due to withdrawal of assets by the proprietor or incurring of liabilities chargeable to him personally.
5. Cancellation of a credit entry or a credit balance transferred to another account.
6. A debit entry or a debit balance transferred from another account.

An account having an appropriate caption should be credited to record:

1. Cancellation or decrease of an asset.
2. Incurring or increase of a liability.
3. A profit or gain.
4. Increase in capital due to contribution of assets by the proprietor or assumption by him personally of business liabilities.
5. Cancellation of a debit entry or a debit balance transferred to another account.
6. A credit entry or a credit balance transferred from another account.

10. The Development of the Journal

In an attempt to make the principle of journalizing as simple as possible, the discussion so far has been

confined to the journal in its most elementary form. In actual practice the two-column journal as here shown—usually referred to as the "general journal"—is used only for opening, closing, and adjusting entries, or in a small business where transactions are few in number. When, however, transactions of the same kind are at all numerous, the clerical work in making the original entry is much reduced and accuracy in posting is rendered easier by segregating, i.e., collecting, similar transactions within a journal wholly devoted to that type of transaction. In this way, after a number of like transactions have been collected in their own book of original entry, they can be posted in total form to the ledger account devoted to that particular type of transaction. This procedure will be fully explained in later chapters discussing different kinds of journals. At this stage of the discussion it is necessary only to state that, as in every business by far the greater number of entries relate to cash, purchases, and sales, separate journals are usually kept for each kind of transaction.

REVIEW QUESTIONS

1. What is a journal?
2. Why are transactions not entered directly in ledger accounts?
3. What is the function of a journal?
4. Define "journalizing."
5. Formulate and explain the rules for determining whether the following classes of accounts should be debited or credited in any given transaction. Explain the application of the principle.
   (a) Asset accounts.
   (b) Liability accounts.
   (c) Income accounts.

(d) Expense accounts.
(e) Capital accounts.

6. (a) Define "debit" in general terms.
   (b) Why is the word "By" used in connection therewith, and is its use necessary?
7. (a) Define "credit" in general terms.
   (b) Why is the word "To" used in connection therewith, and is its use necessary?

CHAPTER XVI

ILLUSTRATIVE PROBLEMS IN JOURNALIZATION

1. Transactions to be Journalized

The principles of journalizing explained in the preceding chapter can be impressed firmly in mind by mentally visualizing, as it were, the debit and credit entries of a number of transactions. The following set of entries is given as exercise of this kind with the suggestion that each item be first mentally journalized and then compared with the correct form of the entries given on the following pages. It is assumed that H. Hart has bought a small retail business. The bookkeeper is instructed to open a new set of books based on the data given below. All items and transactions are to be entered on the general journal. The assets of the business, ascertained by inventories and from the records of the former owner, are as follows:

Cash on hand $500.
Merchandise on hand in store $4,000.
Store and office fixtures (counters, shelves, desks, etc.) valued at $200.
Coal on hand estimated value $25.
Personal accounts owed to Hart by:

B. Bentley	$300
C. Curson	200
D. Daley	100
E. Emery	200

Unpaid notes held by Hart against:

F. Foley	$200
G. Garts	100
H. Huron	200
I. Ingalls	300
J. Jones	300

The liabilities are as follows:

Unpaid personal accounts owed by Hart:

M. Munson	$300
N. Nolan	400
O. Olds	200

Unpaid notes and drafts against Hart held by:

K. Kenyon, draft	$600
L. Lawson, note	500

2. Opening the Books Illustrated

The first entry by means of which the books are opened is prepared by listing the assets in the debit column and the liabilities in the credit column of the journal, with the names of the account headings in the explanation column. As explained in Chapter III, the excess of assets over liabilities constitutes the capital. An account is, therefore, opened to show Hart's capital, thus equalizing the debit and credit entries in the journal, and establishing the equilibrium of the ledger. Sufficient explanatory matter should be added to make clear the nature and purpose of the opening entry, although of course confidential information concerning the terms of the purchase of the business from its former owner and concerning the proprietor's financial arrangements should not be disclosed. A satisfactory entry to appear in the journal would be as follows:

January, 1919

–2–

H. Hart this day begins a retail business and opens a set of books to record the following assets and liabilities:

Cash		$ 500.00	
Merchandise		4,000.00	
Furniture and Fixtures		200.00	
Expense		25.00	
B. Bentley		300.00	
C. Curson		200.00	
D. Daley		100.00	
E. Emery		200.00	
Notes Receivable		1,100.00	
F. Foley	$ 200.00		
G. Garts	100.00		
H. Huron	200.00		
I. Ingalls	300.00		
J. Jones	300.00		
To Notes Payable			$1,100.00
K. Kenyon	$600.00		
L. Lawson	500.00		
" M. Munson			300.00
" N. Nolan			400.00
" O. Olds			200.00
" H. Hart, Capital			4,625.00

3. Transactions in Business

The following transactions take place between January 2 and 20:

2. B. Bentley buys goods from Hart on account $50.
   D. Daley buys goods from Hart on account $25.
3. E. Emery gives Hart a check for $50, and a 90-day note for balance of his account.

4. B. Bentley returns to Hart goods which he finds to be spoiled, $10.
6. M. Munson draws a 60-day draft on Hart for $200, which is accepted.
7. F. Foley pays Hart $3 interest on note held.
8. D. Daley sends goods to Hart which the latter buys from him for $35.
9. A draft Hart drew on B. Bentley for $175 has been accepted.
10. Hart purchases a typewriter on a 30-day note $60.
11. Hart Sells merchandise to H. Johnson on account $75.
13. Hart paid freight bill of N. Y. C. railroad for $15.
15. Hart sold K. Lennon merchandise for $60 on account.
16. N. Y. C. railroad overcharged Hart $4 on the freight bill paid January 13. Claim has been made for same.
17. Hart takes goods from the store for his personal use $40.
18. Hart sent N. Nolan a 60-day note for $250.
20. D. Daley makes a new counter for Hart. Amount credited to his account $15.
21. Hart purchases merchandise from Gibbons & Co. for $300, on account.

4. Purchases and Sales

The entries relating to purchases and sales are simple. Every purchase of merchandise for resale is debited to Purchases account and credited to either (1) Cash, if a cash transaction, (2) a customer's account if on credit, or (3) to Notes Payable if Hart accepts a draft drawn on him or if Hart gives his note in exchange. A purchase of fixed assets for the business is debited to a suitably named asset account and credited as above. Thus the transactions of January 10 and 18 relating to the purchase of a typewriter and to

the cost of constructing a new store counter are clearly equipment to be used in the business and as such are debited to the asset account Furniture and Fixtures. The credit in the case of the typewriter is to the liability account Notes Payable and in the case of the counter is to the credit side of the account with D. Daley, who is both a customer and a creditor of the store. Every sale of merchandise is credited to Sales and debited to Cash, a customer's account, or Notes Receivable, as the case may require.

5. Receipts and Payments

Receipts shown in the transactions are debited to Cash and credited to either (1) the person from whom the amount is received if it extinguishes a debt owed to the business, or (2) an income account if a source of income. Thus the transactions under January 4 and 9 involve the crediting of the persons making payments, while the receipt of January 7 is credited to the income account of interest. In this case the payment of $3 made by Foley represents not the extinguishing of a debt but the payment of interest earned by the business for the credit extended to Foley. If it were required to show on the books that Foley owed Hart $3 for interest, Foley's account would first be debited and interest credited. Upon receipt of the interest Cash would be debited and Foley's account credited and closed, leaving the two contra entries as shown in the example in § 7.

Payments made by the business, shown in the transactions, are credited to Cash and debited to either (1) the person to whom the amount is paid if it extinguishes

a debt owed by the business, (2) a suitable expense account if the amount represents an expenditure made for the purpose of carrying on the business, or (3) an asset account if an asset was acquired. Thus, an account opened with Freight and Express is charged with the amount paid for this service on January 13. If it were desired to show on the books the fact that the business owed the N. Y. C. Railroad Company $15 for freight, Freight and Express account would be debited and the railroad company credited. Upon payment of the freight, Cash would be credited and the railroad company's account debited and closed, leaving the two contra entries as shown in the example. Freight charges of this kind are usually paid in cash.

6. Returns and Allowances

Transactions which represent the return of goods bought or sold, or an allowance on the original invoice price entered on the books, are handled by a contra entry in the accounts affected. Thus when merchandise is returned by a customer as in the transaction of January 5, the customer is credited with their value and Sales account is debited. When the N. Y. C. railroad overcharges on its freight bill and a claim is made for the excess charge, the railroad is debited and the expense account is credited with the amount, as in the transaction of January 16. In the first case a debit to the income account Sales decreases income by the amount of the returned goods, and in the second case a credit to the expense account Freight and Express decreases expense by the amount of the claim or allowances.

7. Solution of Journal Entries

The correct form of journal entry for each of the foregoing transactions is shown below. By following the explanation given, no difficulty should be experienced in journalizing the ordinary transactions met with in every business as here illustrated:

January, 1919

–2–		
B. Bentley	$ 50.00	
D. Daley	25.00	
To Sales		$75.00
–3–		
Cash	50.00	
Notes Receivable	150.00	
To E. Emery		200.00
–4–		
Sales	10.00	
To B. Bentley		10.00
–6–		
M. Munson	200.00	
To Notes Payable		200.00
–7–		
Cash	3.00	
To Interest		3.00
–8–		
Purchases	35.00	
To D. Daley		35.00
–9–		
Notes Receivable	175.00	
To B. Bentley		175.00
–10–		
Furniture and Fixtures	60.00	
To Notes Payable		60.00

– 11 –		
H. Johnson	75.00	
To Sales		75.00
– 13 –		
Freight and Express	15.00	
To Cash		15.00
– 15 –		
K. Lennon	60.00	
To Sales		60.00
– 16 –		
N. Y. C. Railroad	4.00	
To Freight and Express		4.00
– 17 –		
H. Hart, Drawing Account	40.00	
To Sales		40.00
– 18 –		
N. Nolan	250.00	
To Notes Payable		250.00
– 20 –		
Furniture and Fixtures	15.00	
To D. Daley		15.00
– 21 –		
Purchases	300.00	
To Gibbons & Co		300.00

REVIEW QUESTIONS

1. Enter the following transactions in a two-column journal:
   1. W. Smith began a general grain business by investing cash $9,000; office furniture $500; and stock-in-trade as follows: 2,000 bu. wheat at $2.50; 3,000 bu. corn at $1.
   2. Paid the following bills in cash: rent $60; office supplies $20; office furniture $75.
   3. Bought of C. Jones 500 bu. corn at $1.05, terms 2/10 n/30.

4. Bought of A. Haskins 500 bu. wheat at $2.40, terms 2/10 n/30.
5. Bought of D. Revell 400 bbl. flour at $12.
6. Sold S. Swallow 800 bu. wheat at $2.75 on account.
7. Sold O. Green 700 bu. corn at $1.15 on account.
8. Sold H. John 90 bbl. flour at $18 on a 30-day note.
9. Discounted personal 90-day note at the bank. Face of the note $7,000; discount $70.
10. Returned to D. Revell 15 bbl. flour of poor quality. Received credit memo for same.
11. Drew for personal use $200 in cash.
12. Paid in cash: clerk hire $35; cleaning bill $3; tips to porters $2.
13. Bought of N. Lord 600 bbl. potatoes at $3, terms 2/10 n/30.
14. Sold I. Cooper 400 bu. wheat at $2.73, terms 2/10 n/30.
15. Donated to the Infants' Welfare Association 2 bbl. flour at $12, cash $10.
16. Sold C. Brown 200 bbl. potatoes at $3.20 on account.
17. Paid C. Jones on account $375, discount received 2%.
18. Paid H. Haskins cash in full of account, discount received 2%.
19. Sold K. Olin, on 15-day note, 700 bu. wheat at $2.80.
20. Purchased store property for $4,000 cash.
21. Paid in cash: gas bill $10; telephone bill $15.
22. Gave C. Jones 30-day note for balance of account.
23. Discounted note of H. John at 5%.
24. Gave S. Revell 15-day note for $3,000.
25. Paid in cash, repairs to furniture $7.

CHAPTER XVII

THE CASH BOOK

1. Segregation of Like Transactions

In every business where transactions are numerous the modern practice is to segregate the original entries of like kinds and record them in separate books. Much time and labor is thereby saved in posting and the accuracy of both the journal and ledger entries is more easily insured. In this part of the book the splitting up of the general journal into "subsidiary" journals, as they are termed, will be discussed, leaving for later consideration (Chapter XXIV, "Controlling Accounts") the application of the same process to the general ledger.

2. Advantages of Subdivision of Journal

The advantages of subdividing the general journal into several subsidiary journals can be readily illustrated by an example. Let us assume that a concern sells goods on the instalment plan of payment. The items of cash received might then run into hundreds and even thousands daily. If a general journal only were used, a complete entry would need to be made for each cash receipt as follows:

Cash	$5.00	
To John Doe.....		$5.00

It is clear that the work could be shortened by first

listing the names of customers and amounts received each day in some form of memorandum book and then journalizing them in one composite entry in the following form:

Cash	$47.00	
To J. Doe		$5.00
" T. Smith		10.00
" J. Jones		17.00
" F. Jackson		15.00

To copy the names of persons involved in cash transactions first in a memorandum book and then in a general journal preparatory to posting them to their ledger accounts obviously creates a needless duplication of entries. It is much more convenient and practical to use such a memorandum book as a permanent record for original entries of cash transactions. So in every modern accounting system the work is curtailed by dispensing with a journal entry in the general journal and utilizing a cash journal or cash book for the purpose of journalizing the transactions involving cash.

3. Development of Cash Journal

It is apparent that in a journal devoted to the record of cash transactions the mere entry of an item such as:

John Doe..... $5.00

indicates the receipt of $5 from or its payment to the person named. If, furthermore, all receipts are entered on the left-hand page and all payments are

entered on the right-hand page, then the two facing pages of the cash journal virtually constitute the whole detail of the debit and credit sides of the cash account in the ledger. All that is now required to complete the double-entry record on the books is to post all cash receipts to the credit and all cash payments to the debit of the accounts named in the journal. The facing pages of the cash journal serve as the ledger account and the recording of each cash transaction, whether it be a receipt or payment, entails only one entry in the cash book and one in the ledger and still the principle of double entry and the journalizing of transactions is maintained.

As in almost every business the cash transactions are much more numerous than those of any other kind, modern practice almost invariably makes use of a cash book. It is possible to make the cash book serve the double purpose of journal and ledger account and to dispense with a cash account on the ledger. This practice, however, is not to be recommended and, for reasons to be explained presently, the safer course is to open a Cash account in the ledger.

4. Receipts and Payments in Separate Books

In a business in which cash transactions are numerous, receipts and payments may be entered in separate books so that more than one clerk can be used in keeping them. When the cash journal is divided into separate books, the usual practice is to open a Cash account on the ledger to which summary totals of receipts and payments for each month are posted. The ledger is thus made self-balancing.

5. Cash Book Form

The form of cash book shown below is adequate for ordinary double-entry bookkeeping in which the transactions are neither numerous nor complex.

Dr. CASH

Date		L.F.	Account to be Credited	Explanation	Amount	
1919						
Mar.	1	√	Balance		$2,431	72
	1	71	Jones & Curtis.....	On account	100	00
	1	28	Thompson & Brown.....	On account	75	00

CASH Cr.

Date		Check No.	L.F.	Account to be Debited	Explanation	Amount	
1919							
Mar.	1	42	15	Office Salaries.....		$ 81	00
	1	43	57	Gould & Lambert.....	In full of Inv.	840	00

Form 2. Cash Book—Simple Form

6. Petty Cash

The distinction between "cash" and "petty cash" may here be noted. Petty cash generally refers to a separate fund of currency of a relatively small amount, kept distinct from the general cash on deposit or to be deposited in a bank. This fund is usually kept in the office for the purpose of making small payments such as postage, carfare, small office expenses, and the like. The method of recording petty cash payments will be described in Chapter XX.

The following points in recording transactions in the cash book need to be noted:

7. Dates

The month in which the entries are made is written plainly at the top of each page so as to be readily apparent on opening the cash book. The date of the receipt or payment is entered at the left. There is no reason why the date should not be entered in the center of the page, as in the journal, excepting that of convenience. Cash book entries are much more numerous than those in the journal, and to write the date in the middle of a separate line would cause a needless waste of space.

8. Footings

The columns showing cash receipts and payments should be added every day and the totals shown in small pencil figures. This is necessary in order to determine the balance of the account, which is the excess of debits over credits. Whenever the bottom of a page of either receipts or payments is reached, both pages should be added and the amounts carried forward to the next page, even though one side may be only partially filled. In the average business either receipts or payments preponderate so that, for example, ten pages may be required to record the receipts of cash while two pages contain current payments. If in that case both totals were not brought forward when each receipts page was filled, to ascertain the balance of the cash by a quick inspection would necessitate turning back from the page which shows the total of receipts to some preceding page which shows the total of payments. It is much more convenient to have these totals appear opposite each other.

9. Banking Cash Receipts

To insure an adequate cash record, all receipts, no matter how small, should be deposited in the bank. If an amount received is small, the money may, however, be held in the office until a large enough sum accumulates to warrant making a deposit. Whatever may be the procedure, when a deposit is made such deposit should equal in amount the total cash receipts from the time the last deposit was made. For convenience in proving the correctness of the balance shown by the cash book, as will be described later, a deposit should be made on the last day of each month to include all undeposited receipts, if any, notwithstanding the fact that the amount may be smaller than is usually deposited at other times during the month.

Under no circumstances should amounts received be used directly in making payments, nor should small receipts be put in the petty cash fund. The reason is that either practice destroys the confirmation of the correctness of the cash record secured when the bank keeps what is practically a duplicate record. Furthermore, when payments are made with cash received, the proof of payment afforded by a canceled check indorsed by the creditor is lacking, the cash record is complicated with explanations of transactions out of the ordinary, and the record of receipts and payments is incomplete.

10. Identification of Payment

Each payment should be entered in the cash book with sufficient explanatory detail to identify it without reference to any other document or record. Checks should be numbered and the number of each entered in

the cash book. The modern practice is to dispense with the check book stubs by making entries directly in the cash book instead of first on the check stub to be copied later into the cash book.

Sometimes it is necessary to use loose checks which are not attached to stubs or which are not numbered in regular series. In such cases, care must be taken to make at the first opportunity an adequate entry in the cash book for every check so issued. Such a check should be given a number for purposes of identification, a convenient method being to use the number following that of the last regular check drawn. The regular check bearing the number given to the loose check should then be destroyed. Another convenient method is to give the loose check the number of the last drawn regular check preceded or followed by the letter "x." If a loose check is not numbered when issued, a number should be assigned to it later, to be used in the entry in the cash book, and marked on the check when it is returned by the bank after payment. Neglect of these simple precautions may result in an unexpected overdraft of the bank account.

11. Cash Balance

The most vital fact shown by the cash book is the balance of cash on hand. Since the balance is the excess of receipts over payments (the receipts including any balance at the beginning of the period), the totals of both receipts and payments must be kept in order to calculate the balance. To this end the columns should be added daily and the totals inserted in small pencil figures under the last entry in each column. The

balance itself should be entered in pencil in the explanation space on the receipts side of the cash book.

The accuracy of the calculations should be tested frequently; if receipts are numerous, at the end of each cash book page. A convenient method is to add to the former balance all subsequent receipts and to subtract therefrom the subsequent payments; the result should agree with the present balance shown by the excess of total receipts over total payments. If it does not so agree, the mistake should at once be located.

In order to apply this test and in order also to make monthly postings of total receipts and payments, no attempt should be made to balance single pages of the cash book. That is, the balance should not be determined by totaling in ink the receipts and payments on each page, subtracting one from the other and entering the balance or overdraft at the top of the next page. Such a method might lead to mistakes. If the balance at the end of any one page were incorrectly calculated, every balance thereafter during the month or other fiscal period would be incorrect, because each balance forms the base of all subsequent calculations.

12. Closing the Cash Book

It is customary in most offices to close the cash book at the end of each month. There are certain well-known exceptions, as, for example, in a stock broker's office where the cash record is closed daily, and in the theatrical profession where all accounting is done on a weekly basis. Generally speaking, however, the month is the most convenient period for assembling the final information concerning cash receipts and payments and

making the postings from the cash book. The form of cash book presented in Chapter XX shows a convenient way to rule off the cash book at the end of a month preparatory to making the ledger postings.

The total cash receipts for the month should be posted to the debit of the cash account in the ledger. This figure comprises all items which have been posted individually to the credit of the various accounts. The equilibrium of the accounts is thus maintained by making one debit equal to all the credits. Instead of a separate Cash debit for each receipt, the total of the receipts during the month is determined and debited to Cash. The debit to Cash, of course, records merely the increase in that asset. Care should be taken in posting cash receipts not to include the opening balance at the beginning of the month because that balance is already represented in the Cash account.

From the credit side of the cash book the total is credited to the Cash account in order to record the decrease in that asset. During the month accounts have been debited with the separate payments recorded in the cash book, so that the equilibrium is maintained by offsetting the total of these debits with a credit of the same amount. Instead of crediting Cash each time a payment is made, the total of the payments during the month is ascertained and that amount credited to Cash.

In order to show the balance on hand at the end of the month in a neat and orderly way, it is written in ink under the total payments and added to them. It is obvious that if the balance of Cash is the excess of receipts over payments, the sum of the balance and the payments will equal the receipts. The total on each

side of the cash book can conveniently be entitled "total per contra," since the total on each side is the same as the total on the opposite side. It is evident that if postings are made to the Cash account in the ledger as suggested herein, the balance of the ledger account will agree in amount with the balance shown by the cash book.

REVIEW QUESTIONS

1. What are the advantages of entering cash transactions in a cash book?
2. Describe a cash book and show its relation to the Cash account.
3. What should a Cash account in the ledger show?
4. May a Cash account ever have a credit balance? When?
5. Rule a cash book, entering five transactions on the receipts side and four on the payment side. Insert balance, and close.

CHAPTER XVIII

PURCHASE RECORDS

1. Function of Purchase Journal

The purchase book is a separate form of journal designed to relieve the general journal of all purchase transactions. If each purchase were separately recorded among the other transactions entered in the general journal, every entry would have to be posted in detail to the ledger. The detail work can be simplified, without violating any of the principles of double-entry bookkeeping, by recording purchases in one place and posting them in total to the ledger at the end of the month.

2. Simple Form of Purchase Journal

The purchase journal illustrated below resembles a simple two-column general journal. The details of each purchase transaction are entered in the first column and the amount to be credited in the second. The second column is added at the end of the month to secure the total debit to be posted to the ledger.

3. Illustration of Use of Purchase Journal

The use of the purchase journal can readily be understood by comparing the entries of a few transactions first journalized in the ordinary way in the general journal and then entered in the purchase journal. Assume the following business operations in October, 1918:

1. Bought merchandise from A. Maxwell on account $3,878.95.
6. Bought merchandise from W. Hess on account $850.
9. Bought merchandise from Smalley Bros. on 60-day note, $258.
18. Bought merchandise from L. Sadler on 30-day note, $375.09.

Then if the ordinary journal were used in which to record the transactions, the debit in each case would clearly be to the ledger account recording the value of the purchase, i.e., Purchases account, and the credit to an account with the creditor from whom the purchase was made—as shown below:

October, 1918

–1–		
Purchases	$3,878.95	
To A. Maxwell		$3,878.95
–6–		
Purchases	850.00	
To W. Hess		850.00
–9–		
Purchases	258.00	
To Smalley Bros		258.00
Smalley Bros	258.00	
To Notes Payable		258.00
–18–		
Purchases	375.09	
To L. Sadler		375.09
L. Sadler	375.09	
To Notes Payable		375.09

In the above examples four separate debit and credit entries are required in both the general journal

and the ledger to record the purchases. The same purchase transactions entered in the purchase book are reduced to four credits and one debit in both journal and ledger. A separate entry would still be required to record the giving of the note to L. Sadler. This transaction is not a purchase, but is merely the settlement of a liability.

PURCHASE BOOK

Date		L.F.	Account to be Credited		
1918					
Oct.	1		A. Maxwell	$3,878	95
	6		W. Hess	850	00
	9		Smalley Bros.	258	00
	18		L. Sadler	375	09
			Purchases Account Dr.	$5,362	04

Form 3. Purchase Book

One posting to the Purchases account takes the place of the numerous postings necessary if the general journal were used for the original entry of purchases.

4. Purchases Account

The account to which purchase transactions are debited in the ledger and to which reference has already been made in Chapter VIII is known in a mercantile business as Purchases or Merchandise Purchases account. The purchases may be recorded in one or in several accounts, determined by the number of lines on which it is desired to ascertain the gross profits. Gross profit is the excess of the sale price of a given

line over the purchase price. If there were no goods on hand at the beginning of a fiscal period and if all the items of a line purchased during the period were sold out before its close, it is apparent that the gross profit could be readily ascertained. The purchases of the period would then represent the cost of the goods sold and the excess of the selling price over the cost of goods sold represents the gross profits. In actual practice, however, a certain amount of goods is usually on hand at the beginning and end of a period and their values must, of course, be taken into consideration. Before the cost of goods sold can be ascertained, the value of the goods on hand at the beginning —i.e., the opening inventory—must be added to current purchases and from this total the value of the closing inventory must be deducted. There are two methods of determining the amount of the inventory.

5. Perpetual Inventory

A perpetual inventory consists of records (usually in card form) kept to show the amount of merchandise on hand. A separate card is allotted to each line of goods; purchases are debited as goods are received while sales are credited as made, *but at their cost price.* The excess of purchases over sales, i.e., the balance of each card, shows the value of that line of goods on hand, and the total of the balances of all cards represents the cost price of the inventory. If a perpetual inventory is not maintained, the value of the stock-in-trade must be ascertained by counting and listing the various items of merchandise and extending them at their cost price.

6. Operation of Purchases Account

The cost of goods sold may be ascertained by debiting Purchases with the opening inventory and the amount of current purchases as taken from the purchase journal, and crediting it with the closing inventory. In actual practice, however, the Purchases account is more complicated than this. Inward freight often adds to the purchase price of the goods and is clearly a charge to their cost. Purchase items may also be returned to the vendor for various reasons and rebates may occasionally be allowed by the vendor. These should be deducted from gross purchases to arrive at net purchases, and therefore are credited to the account. For the recording of such transactions separate accounts are usually opened under the heads of Inward Freight, Returned Purchases, and Purchase Rebates and Allowances, which are debited or credited, as the case requires. At the close of the fiscal period these accounts may be closed into Purchases account, the balance of which then reveals the cost of goods sold, as here shown:

PURCHASES

1918			1918		
Dec. 31	Opening Inventory, July 1...	$ 9,675.00	Dec. 31	Returned Purchases	$ 3,126.00
	Purchases	58,721.50		Rebates and allowances	520.70
	Inward Freight.	1,860.75		Closing Inventory, Dec. 31..	11,721.55
				Profit and Loss (Cost of Goods Sold during the period).....	54,889.00
		$70,257.25			$70,257.25

The transfer of the balance of Purchases account to the debit of Profit and Loss account for the purpose of showing the gross profit for the period has been discussed in Chapter VIII. All that is necessary here is to note the method of arriving at the cost of goods sold and the accounts which are opened to collect details as to freight and returns and allowances. The debits and credits to these accounts are given in Chapters XXXVI and XXXVII.

The Purchases account may be used to record only the net cost of purchases for the period. In that case it does not take into account the opening and closing inventories and is debited only with purchases and freight-in and credited with returns and allowances. Its balance represents the amount of current purchases and is closed into Trading account as here shown.

PURCHASES

1918			1918		
Dec. 31	Purchases	$58,721.50	Dec. 31	Returned Purchases	$ 3,126.00
	Inward Freight.	1,860.75		Rebates and Allowances	520.70
				Net Purchases for period...	56,935.55
		$60,582.25			$60,582.25

7. Trading Account

This account is a subdivision of the Profit and Loss account and is used only at the end of a period when the books are closed. Its purpose is to show the gross profit on sales. This is determined by debiting Trading account with (1) the opening inventory (ascer-

tained by a physical count or valuation), and (2) the balance of Purchases account; and crediting it with (1) the closing inventory (ascertained in the same way), and (2) the net sales of the period as shown by Sales account to be described in Chapter XIX. The opening inventory plus purchases minus the closing inventory, as we have seen, gives the cost of goods sold; and sales minus cost of goods sold gives the gross profit. This gross profit as shown below is transferred to the Profit and Loss account.

TRADING ACCOUNT

Opening Inventory.....	$ 9,675.00	Closing Inventory.....	$11,721.55
Purchases	56,935.55	Sales	69,889.00
Profit and Loss (Gross Profit)	15,000.00		
	$81,610.55		$81,610.55

The Trading account as described shows how the gross profit is ascertained, and the Profit and Loss account shows the expenses of administering the business while the gross profit was being earned.

8. Estimating the Inventory

As pointed out above, the inventory of goods on hand must be ascertained by physical stock-taking unless a perpetual inventory record be maintained. Stock-taking is inconvenient and costly and thus is usually undertaken only once or twice a year. Yet an approximate inventory at other times may be exceedingly important for two purposes: (a) to establish the value of goods destroyed by fire at a time when the actual

inventory is not known, and (b) to make possible the determination of profit or loss for short periods, e.g., monthly, between times of stock-taking. The approximate amount of the inventory can be ascertained by using the estimated percentage of gross profit in the following manner.

Between stock-taking times, the books usually show the last inventory taken, purchases since that time at cost, and sales during the period at selling price. If the probable percentage of gross profit is known, the gross profit can be estimated by applying this percentage to the amount of the sales. Subtracting the gross profit from the sales gives the cost of goods sold. It is evident, then, that the inventory can be approximately ascertained by subtracting the cost of goods sold from the total amount of goods available for sale, i.e., the opening inventory plus the purchases. This test should be applied to all trading accounts to disclose any errors due to incorrect stock-taking.

This may be illustrated by using the Trading account shown in § 7:

Inventory at beginning of period		$ 9,675.00
Purchases during period		56,935.55
Total Merchandise available for sale		$66,610.55
Deduct Cost of Goods Sold:		
Sales	$69,889.00	
Less Gross Profit (21½%)	15,026.14	54,862.86
Estimated Inventory at end of period		$11,747.69

The actual inventory shown in Trading account was $11,721.55.

REVIEW QUESTIONS

1. What is the function of a purchase journal or book?
2. What advantages accrue from keeping a Purchases account in the ledger?
3. What should such an account show?
4. Rule a purchase book, entering therein seven transactions. Then close it.
5. Explain how the amount of an inventory can be estimated.

CHAPTER XIX

SALES RECORDS

1. The Function of the Sales Journal

The sales journal, sometimes called "Sales Register," "Sales Record," or "Sales Book," is a separate form of journal designed to relieve the general journal of all sales transactions. Entries made therein show the analysis of these transactions into their component elements so that the proper accounts may be debited and credited.

Comments on the inadequacy of the general journal as a book of original entry for recording purchase transactions are equally applicable to the general journal as a book of original entry for sales transactions. The use of the sales journal makes it possible to segregate and post in summary form all transactions of a like nature. One credit for a monthly total can be made to the Sales account in the ledger, the offsetting debits being made currently to the customers' accounts in the general ledger, or in a sales ledger if one is maintained.

2. Form of Sales Journal

The simplest kind of sales journal is identical in form with the purchase journal and the method of its operation is the same except that the debiting and crediting are reversed. Individual sales are debited to the accounts with the customers whose names are entered in the explanation space but only one credit is made for

the total sales at the end of the month. Following is a simple form of sales book.

SALES BOOK

			Accounts to be Debited			
1918						
Oct.	5		A. Carpenter		$ 400	00
	10		A. Morton		148	50
	25		H. Fox		841	30
	28		A. Dix		832	40
			Sales Account Cr.		$2,222	20

Form 4. Sales Book

In Chapter XXIII a more elaborate sales book is shown and more complex transactions are recorded. In the present chapter attention is called to certain fundamental characteristics of the recording of sales regardless of the form of the sales journal and the number of sales accounts carried in the general ledger.

3. Sales Account

The purpose of the Sales account is to show the sales for the period, and as many sales accounts may be opened as there are lines or departments, the sales of which it is desired to record separately. At the close of each month the Sales account is credited with the total sales for that month. In order to indicate the actual or net sales, Sales account should be debited with returned sales and with all allowances made to customers except cash discounts. To record the amount of returned sales an account by that name is generally maintained, the

balance of which may be transferred to the debit of the Sales account. Likewise, an account to record allowances to customers may similarly be kept, the balance of which may be transferred to the Sales account. The balance of the Sales account will then represent the net sales for the period and should be transferred to the Profit and Loss account, as explained in Chapter VIII.

4. Sales to Proprietor

A proprietor often will withdraw merchandise for his own personal use and the accounting for such withdrawals should be properly handled. If they are ignored on the theory that the proprietor owns the merchandise and thus is entitled to withdraw it for his personal use, the trading results will not be correctly stated because the cost of such merchandise has been included in the purchases and unless credit is given to the business for the merchandise withdrawn the gross profit will be understated. The easiest way to record such withdrawals is to bill them in the regular way to the proprietor and to enter the sale in the sales journal as if it were one to a customer. The debit in that case would be made to the proprietor's drawing account instead of to a customer's account. Generally speaking, there is no reason why the proprietor in his drawing account should not be charged with the selling price of the merchandise. If, however, he insists upon withdrawing it at cost, the most exact method of recording the withdrawal would be to treat it like a returned purchase. In strict accuracy merchandise withdrawn at cost should not be credited to Sales account because it is not sold at the usual selling price and the percentage of gross profit

on sales will be understated if it is credited to sales. When, however, the withdrawals are infrequent and the sales are numerous it is entirely practicable to enter the withdrawals as sales in the sales journal notwithstanding the fact that they are at cost price. The effect of such withdrawals on the percentage of gross profits will usually be negligible.

5. Returned Sales

It is usually impossible to avoid the return of merchandise by customers to whom it has been sold. Such returns may be due to defects which were not noticed at the time of shipment or they may be permitted merely as a means of satisfying a customer's whim in order to retain his good-will. For whatever reason the returns are made the amount should be clearly indicated in the accounts. If returns are not numerous they may be entered in the sales journal, the figures appearing in red ink in order to indicate that the customer's account will be credited instead of debited with the amount of the sale which was returned. Where returned sales are numerous a separate journal or a separate section of the sales journal should be provided for them. The posting and the other bookkeeping procedure in connection with the returned sales are identical with those described in Chapter XVIII for returned purchases, except, of course, that the debits and credits are reversed because customers instead of creditors are involved.

6. Significance of Turnover

The turnover of merchandise, sometimes called "stock turn," signifies its sale and conversion into ac-

counts or notes receivable or cash. It is desirable for the proprietor to turn over his merchandise as frequently as possible in order that the general expenses, such as rent, salaries, and the like, which must be deducted from the gross profit, will be relatively low. Since gross profit is the excess of selling price over the cost of goods sold it does not depend at all upon the element of time. If the same volume of goods can be sold in five months instead of six, the gross profit would be the same, but in the latter event the net profit is greater because the general expenses which depend upon the element of time would be reduced by one-sixth. This fact should be realized by every proprietor.

Since turnover is the repeated use of the same capital invested in changing merchandise, it is clear that one must compare the inventory (merchandise available for sale) with the sales (merchandise which has been sold). It is clear also that in this comparison the cost of goods sold and not the amount realized on the sales must be used because inventories are stated at cost and comparison should be made only between like elements. To compare sales at selling prices with inventory at cost or vice versa would be meaningless. In order to calculate the turnover for a period, the cost of goods sold during the period should be divided by the average inventory on hand during the period. Turnover should be stated as a percentage of the average inventory on hand. For example, if the cost of goods sold was $3,000 and the average inventory $2,000, the turnover would be 150%. For convenience it would be stated as 1.5. In other words, the stock has been turned over one and one-half times.

REVIEW QUESTIONS

1. What is the function of a sales record?
2. Describe a sales record and show its relation to the merchandise sales account.
3. What should such an account on the ledger show?
4. Rule a sales book and enter therein eight sales transactions. Then close it.
5. Show the relation of a sales record to the journal.

Part IV
Development of Journals

CHAPTER XX

MISCELLANEOUS CASH MATTERS

1. Development of Modern Cash Book

The simple form of cash book described in Chapter XVII does not state the exact truth in that the total receipts may be inflated by the amount of discounts allowed customers or similar items, while payments may be inflated correspondingly by entering on the credit side items which are merely offsets to inflated debits. Because of this deficiency such a record is inadequate for a business in which cash transactions are at all numerous and is suited only to the most elementary type of bookkeeping. To meet modern accounting needs a more elaborate form of cash book is required which by the use of separate columns shows total receipts and payments, the discounts received and allowed, if any, and net receipts and payments. The form of such a cash book is illustrated below.

As will be seen, by examining the illustration, the sum of the discount column and the net column equals the sum of the sundries column. At the close of each month the footing of the net cash column should be debited to the Cash account, and the footing of the discount column posted to the debit of Discount on Sales account. The items in the sundries column are separately posted to the credit side of the proper ledger accounts. At the close of each month the footing of the net cash column on the credit side should be credited to

Dr. CASH

Date	L.F.	Account to be Credited	Net Cash	Discount on Sales	Sundries
1919					
July 1	√	Balance	$3,000.00		$3,000.00
20	104	Cash Sales	193.28		193.28
21	41	Notes Payable	500.00		500.00
22	181	A. Johnson	334.92	$6.84	341.76
28	172	O. Olp	180.00		180.00
28	101	Cash Sales	88.36		88.36
29	167	O. James	261.90	8.10	270.00
	√	Total per contra	$4,558.46	$14.94	$4,573.40
	√	Deduct—Balance July 1	3,000.00		
	2	Cash Receipts	$1,558.46		

Form 5. Cash Book, showing

Cash account. The footing of the discount column on the credit side is credited to Discount on Purchases account. The items in the sundries column on the credit side should be debited to the proper ledger accounts. As heretofore noted, all receipts entered in the net cash column should be deposited in the bank, and all payments entered in the net cash column should represent checks issued, excepting a monthly charge for exchange.

Instead of the single discount column, as shown on the form, two columns for deductions may be maintained on each side of the cash book, one for discounts and another for interest; but this is seldom necessary. The

CASH Cr.

Date	Check No.	L.F.	Account to be Debited	Net Cash	Discount on Purchases	Sundries
1919						
July 8	143	61	Printing and Stationery	$ 20.00		$ 20.00
11	144	67	Insurance	18.00		18.00
14	145	80	Drawing Account	25.00		25.00
17	146	217	A. C. Deacon	472.68	$14.62	487.30
17	—	62	Exchange	59		.59
21	147	63	Interest	7.50		7.50
24	148	50	Notes Payable	250.00		250.00
24	148	63	Interest	2.50		2.50
26	149	210	H. White	150.00	7.89	157.89
29	150	221	F. Sanders	90.00		90.00
30	151	64	Salaries	98.50		98.50
30	152	65	Rent	50.00		50.00
		2	Cash Payments	$1,184.77	$22.51	$1,207.28
		√	Balance July 31	3,373.69		
		√	Total per contra	$4,558.46		

Net Receipts and Payments

items of cash discount usually occur much more frequently than interest, so that the column for deductions may be headed "Discount." In case a note is discounted the interest deducted may be entered in the discount column in red ink, or in black ink with the abbreviation "int." written at the side of the amount. At the close of the month, the footing of the discount column should be analyzed, and the amount of interest items and discount items shown separately in the place where the single footing would appear if there were no interest items. The two totals should then be posted separately.

2. Exchange

A charge for exchange when out-of-town checks are deposited in the bank sometimes causes bookkeeping perplexity. Such a charge is made for collecting checks drawn on out-of-town banks and range from 1/10 to 1/4 of 1% of the amount of the deposited check—with a certain minimum. Exchange charges are fixed in each locality by the local association of banks known as the clearing house. Three methods of making the charge to the depositor for this service are in general use.

The first method is to deduct the exchange from the amount of the deposited check and to enter in the bank pass-book only the net amount after this deduction. The second is to enter in the pass-book the full amount of the check deposited, but to keep a record of exchange charges and to charge the depositor with the total at the end of each month. This charge is usually effected by the bank's reducing the depositor's balance and notifying him by some form of debit memorandum, the amount of which is generally added to the total of the depositor's checks paid by the bank and returned canceled to the depositor. A third method is to allow the depositor to pay the amount of the exchange when making the deposit. Under this method the full amount of the deposited check is entered in the pass-book and no charge for exchange is made later.

Upon request a bank will generally permit a depositor to pay exchange at the time of deposit, the exchange charge being usually paid from the petty cash fund. This method is recommended as the simplest and has the further advantage of enabling the depositor to prove the bank's charge at the time it is made. Under

the method of making a monthly charge in total, the depositor must either accept the bank's charge as correct or verify it by a detailed examination of his deposits. Such an examination is usually laborious and occasionally puzzling. If either the first or second method be followed, entries must be made in the cash book to record the exchange. The cash book should then show the amount of the receipt before any deduction for exchange because the debtor is usually entitled to credit for the entire amount received, the exchange being an expense to be borne by the depositor; hence, the entry for the exchange should be made on the payments side of the cash book.

3. Exchanged Checks

Checks which are exchanged for mutual convenience have nothing in common with the bank exchange under discussion. The expedient of exchanging checks may be used for extending or procuring credit, as when one of the checks is postdated or one of the parties to the exchange agrees not to deposit the check received until some later time. The term "exchanged checks" is applied also to checks drawn for cash received to provide the person to whom the check is given with a form of credit convenient for some particular use, such as transmitting it by mail. Sometimes, in the collection of an account receivable, the debtor gives a check drawn by a third person to the debtor's order for an amount larger than the account to be settled; whereupon a check may be given to the debtor for this excess. A check drawn for this excess is an exchange check and that received from the debtor should be so designated

to the extent of the excess over the amount of the account which is settled.

Although exchanged checks do not affect the balance of the depositor's account, both their receipt and payment should be entered in the cash book with a sufficiently complete notation of the facts of the exchange to identify the transaction. Such an entry is necessary to provide a complete record of deposits made and checks drawn. The record would be particularly valuable if the check deposited were returned by the bank as worthless or if the check given in exchange should not be presented for payment before the next balancing of the account by the bank.

4. Interest on Deposits

An item which requires entry on the receipts side of the cash book is interest allowed by the bank. Many banks allow a low rate of interest on a depositor's account when the amount reaches a certain size prescribed by the bank. For example, 2% per annum may be allowed on every daily balance of $500 or more; that is, for every day when the depositor has at least $500 in the bank he receives interest on his balance at the rate of 2% per annum. Incidentally it may be mentioned that the practice of most banks is to calculate this interest on even hundreds only; so that a balance of $499 draws no interest and a balance of $599 draws interest on $500 only. The bank generally adds the interest to the depositor's account and notifies him by noting the amount of the interest in the pass-book or in a monthly statement submitted to him. The entry made by the bank is usually designated as interest and

thus can readily be distinguished from credits for deposits. A similar entry must be made in the cash book and included in the total receipts.

5. Notes and Drafts Collected

If a note or draft has been taken by the bank for collection, its particulars are usually entered as a memorandum receipt in the back of the pass-book. After the note or draft is collected, the bank adds the amount to the depositor's account. The depositor is usually notified of the collection only when the pass-book is balanced by the bank or when he receives the next monthly statement and finds the amount collected added to his deposits. It is the practice of banks, however, to notify the depositor if the note or draft is not collected. Consequently, if no notice of non-collection is received at the maturity of the instrument, the depositor may assume that collection has been made, but he should confirm this by inquiry at the bank. Upon confirming the collection the depositor makes an entry of the amount collected in the cash book as a cash receipt.

When the party primarily liable on a note or draft left at a bank for collection fails to pay it at maturity and the depositor has given no instructions not to protest the instrument, the bank has it protested and charges the protest fees to the depositor. In that event the only entry on the cash book is for the protest fees, and whether the bank's practice is to require a check from the depositor for these fees or to deduct them from his account without a check, the depositor should enter them on the payments side of the cash book. Pro-

test fees are usually chargeable to the person whose failure to pay an instrument necessitated the expense of the protest; hence the entry in the cash record should clearly identify the instrument and name the person.

6. Deposits Charged Back

Occasionally an item deposited is returned by the bank as rejected. The most common example is a customer's check that proves to be worthless and is consequently returned to the depositor by his bank, which deducts the amount from his account. The depositor should then enter the amount of the returned item on the credit side of the cash book so as to include it in the total payments.

This procedure is preferable to that of deducting the returned check from the total receipts shown on the cash book, partly because there is no convenient way of making subtractions of this kind and partly because the receipts shown on the cash book should agree with the deposits shown by the bank's records. If subsequently the same item is redeposited, it must again be entered on the receipts side of the cash book.

7. Notes Paid for Depositor

The cash book should contain an entry of every note paid by the bank for the depositor. Whenever a note payable at a bank is executed the maturity date and the amount should be entered in some collateral record so as not to escape attention. At the maturity of the note its amount including interest, if any, must be entered in the cash book as a payment. The general practice of banks is to pay such a note without consulting

the maker and to return the canceled note to him with the interest, if any, indicated thereon, when his paid checks are returned.

8. Bank's Charge for Carrying Account

Banks sometimes charge a fee for keeping an account whenever its balance falls below a specified amount. For example, a bank may charge $1 a month if the average daily balance falls below $250. Such a fee is brought to the attention of the depositor usually by the inclusion of a debit memorandum with the paid checks returned by the bank. Upon receiving notification of the charge the depositor should enter the amount in the cash book as a payment.

9. Void Checks

If, for any reason, a numbered check is made void before it is issued, an entry should be made in the cash book showing that the check has been canceled. This entry is advisable in order to account for all numbered checks. If a check, after it is issued, is returned by the payee unaccepted, as for instance, when a payee claims that it is not for the correct amount, the cash book should include the returned check among the receipts. The entry for the returned check should identify it by number and give a concise statement of the reason for its return. The amount should, of course, be credited to the account to which it was originally charged. If no record be made of it except by erasure (which is always bad practice), there would be no indication that the payee had returned the check though business relations might thereby be affected.

10. Form of Bank Statement

The following form is typical of the statements used by banks in large cities in lieu of balancing the pass-books:

Month of January, 1919
CAMPBELL & JOHNSON, INC.
In Account With
FIRST NATIONAL BANK

Previous balance and credits listed below..... $880.84
Total of 36 debits per machine list attached..... 542.50

Feb. 1, 1919, Balance forward..... $338.34

Please examine at once. If no error is reported within ten days the account will be considered correct.

CREDITS ONLY

Date	Item	Amount	Date	Item	Amount
1919			1919		
Jan. 1	Balance	$245.24	Jan. 20		$ 21.25
4		11.50	23		35.00
5		22.00	24		47.00
6		10.00	26		54.50
8		5.00	31		17.10
9		113.00			
10		42.00			
11		43.00			
13		64.00			
16		116.00			
18		34.25			

Please call for your statement on the SECOND BUSINESS DAY OF EACH MONTH and preserve it carefully, using PASS-BOOK as Receipt for Deposits.

Form 6. Monthly Bank Statement

In the above form the debits are shown in total only; but the number of debit items is noted on the statement and they are listed on an adding machine list which is submitted with the statement. The debits referred to are, of course, the checks drawn by the depositor and paid by the bank, which are returned with the statement after cancellation. The credits listed on the bank's statement are the balance at the beginning of the period covered by the statement and the deposits made during the period. These credits will be identical with the entries in the pass-book, provided that every deposit has been entered therein. Sometimes deposits are made when the pass-book is not available; in that case a receipt in the form of a duplicate deposit slip should be secured from the bank. These slips should be destroyed after the bank has credited the deposits in the pass-book or on a statement.

Sometimes a more elaborate form of statement is used which shows the checks in detail with the dates of their payments instead of merely a total of the checks itemized on an adding machine list.

11. Reconciling Cash Book Balance with Bank Balance

Since the balance of cash on deposit is the most vital fact shown by the cash book, the correctness of this balance should be verified regularly. At the end of each month the state of the account as shown by the bank's records should be ascertained and compared with the balance shown by the cash book. The bank will advise the depositor as to the amount of his balance, either by sending him a monthly statement or by noting the balance in his pass-book.

12. Method of Reconcilement

If the balance at the end of the fiscal period as shown by the bank's statement is not identical with the balance shown by the cash book, the two should be reconciled. Only in this way can the balance shown by the cash book be verified. The reconcilement forms no part of the cash book and the balance shown by the bank does not, as such, appear thereon.

The canceled checks returned by the bank are examined to see that no change has been made in the amount of any check. If all receipts have been deposited and all checks issued have been paid, the balance in the bank, as shown by the bank statement or by the pass-book, will equal the balance of cash on hand, as shown on the cash book. If all checks have not been paid, the amount of unpaid checks must be deducted from the bank's balance in order to reconcile the balance of cash in the bank with the balance as shown by the cash book.

The bank's statement may reveal items properly charged or credited by the bank which have not been entered on the cash book, as interest, exchange, and bank charges for maintaining the account. If such items appear on the statement, the necessary corrections should be made in the cash book at once, prior to making any attempt at reconcilement. Care must be taken to account for all checks shown by the cash book as issued during the month. The paid checks returned by the bank may run numerically without a break and yet one or more of the last checks issued during the month may not be included among those paid.

When a reconciliation has been accomplished, a

statement thereof should be entered in the cash book in ink in any available space near the entry of the balance. Such a statement should be substantially in the following form, care being exercised to show the number of each outstanding check.

RECONCILEMENT WITH BANK

January 31, 1919

Balance per cash book		$73.96
Add—Outstanding checks:		
#147	$28.50	
155	22.50	
162	7.75	
163	100.00	
164	100.00	
165	5.63	264.88
Balance per bank		$ 338.34

In making the next reconcilement the paid checks returned at that time must be examined to ascertain whether or not they include all those outstanding at the time of the preceding reconcilement. If not, those still unpaid must be included in the list of outstanding checks used to reconcile the balance. When a check has been outstanding for several months, the matter should be investigated. If the check has not been received by the payee, a new check should be issued and entered in the usual way. Payment of the lost check should be stopped by an order to the bank and the cash book adjusted to show cancellation of that check, as explained previously. Thereafter the canceled check should not be counted as outstanding.

13. Bank Columns on Cash Book

Sometimes it is advisable to indicate in the cash book both the amount of the bank balance and the cash on hand in the office, although it is rarely desirable for the cash book to record anything except money deposited in the bank. Small cash payments should be handled through a petty cash system which will be described later. When circumstances are such that it is necessary to record in one book cash on hand as well as in bank, a bank column may be provided on each side of the cash book to show deposits and checks in addition to columns for cash transactions. When there is more than one bank account, it is convenient to have a column for each bank on both sides of the cash book so that the respective balances may be indicated. A column for the total receipts and for the total payments, each to contain both cash and bank transactions, should also be provided.

14. Transfers Between Banks

Where the cash book does not indicate by columns the balance on deposit in each bank, a transfer from one bank to another should be recorded as a memorandum or as a debit or credit to ledger accounts with the banks affected. When, however, cash book columns are ruled for individual banks with a total column on each side for the total deposits and total checks, a transfer from one bank to another should be recorded in the following manner:

Assuming a transfer of $100 from Bank A to Bank B, the amount may be entered in red ink (in order that it may be ignored in calculating the total receipts) on the debit side of the cash book in the total column. The

amount should be entered also in the deposit column for Bank B, the latter entry being in black ink, because there has been an actual deposit in Bank B. The entry in the total column is needed to make possible a proof of the footings by cross-footing the page totals. On the credit side of the cash book the amount should also be entered in the total column in red to indicate that there has not been an actual withdrawal of funds. The amount of the check should be entered in black ink in the Bank A column because an actual check has been drawn on that bank.

15. Petty Cash

The term petty cash signifies a fund of currency kept in the office for use in making small payments. Petty cash funds are used in practically all businesses and vary in amount with the demands made on them. In small offices the fund may be as low as $5; in large offices it sometimes exceeds $1,000. Whatever its size, the record of the fund may be kept most conveniently by the method proposed below.

The record of petty cash is frequently neglected because of the relatively small amount involved and because of ignorance of a simple method of recording payments. Such neglect should not be permitted.

16. Creation of the Imprest Fund

The first requirement of any adequate petty cash system is that a fund shall be created and renewed only by duly recorded payments from the general cash. Money received by the business should not be added to the petty cash fund but should be deposited in a bank.

Of many methods of handling petty cash, the following, known as the "imprest" method, is almost always to be recommended.

The petty cash account representing the fund is debited for:

1. The amount of the fund created to meet currency disbursements.
2. The amount of any increase if the fund is to be increased.

The petty cash account is credited for:

1. The amount of any decrease if the fund is to be decreased.

The balance should always represent the amount of the imprest fund.

The account should not be debited or credited after the fund is established and the proper amount debited to this account, except when the fund is either increased or diminished. The contents of the imprest fund drawer should always agree, in cash, or cash and vouchers, with the amount of the fund as shown by the account with the fund.

No payments should be made from the fund except those that must be paid in currency. Such payments would be for small disbursements, and then only when a check would not be practicable or acceptable to the payee. The pay-roll, for example, should never be paid from this fund.

The first step in establishing the fund is to draw a check adequate to meet the demands upon the drawer for, say, one month. This check should be converted

into currency and this currency be placed in a drawer or other receptacle to be used for the imprest fund only. The amount should be charged to Petty Cash account.

Each currency disbursement from the fund should be supported by a voucher, and be recorded in the petty cash book. At the close of the period determined upon, or when the fund requires replenishing, a check should be drawn for an amount equal to the disbursements. This will bring the fund up to the original amount. Whenever the fund is replenished an entry should be made in the cash book charging the proper accounts as shown by a summarized analysis of the disbursements, made up from the petty cash book. The vouchers should be filed numerically, according to months.

REVIEW QUESTIONS

1. (a) Rule a cash book with three columns on a side.
   (b) Enumerate the advantages to be secured by its use.
   (c) Describe the method of posting from such a book.
2. Describe the peculiarities of one or more cash books with which you are familiar.
3. Outline in detail some method of handling cash receipts.
4. The cash balance for our cash book is $3,350. The bank balance per the bank pass-book, on the same day, is $3,705. Checks outstanding, numbers 931, 932, 934, 953, amount respectively to $96, $152, $52, $55. Reconcile the cash book balance with the bank balance.
5. A petty cash fund of $200 is created. Subsequently the following payments are made therefrom: postage $40; carfare $3; office supplies $100; stationery $30. Make the entries necessary to create the fund, to take up the payments made therefrom, and to close out the fund, restoring the cash remaining therein to general cash.

CHAPTER XXI

MISCELLANEOUS PURCHASE MATTERS

1. Simple Form of Modern Purchase Journal

The purchases of a business increase in volume or variety or both in proportion to its growth, and as a means to successful management it is necessary to show the purposes for which purchase expenditures are made. This is effected by dividing the business into departments and classifying purchases by departments so far as possible. Thus a concern which buys for resale will usually base the departmental division of the business on the different lines of goods sold, as in the case of a department store. A manufacturing concern divides its varied activities into those departments the cost of which it is desirable to record separately on the books. This division of the concern into a number of smaller businesses, as it were, necessitates the classification or segregation of purchases in the books of original entry so far as is possible by departments. Additional columns are then needed in the purchase journal to show the monthly total of purchases made for each department. The following form is an example of a simple type of journal in which purchase expenditures made for the needs of particular departments are so classified.

2. Fiscal Periods

In the study of the following form the first feature to be noted is the date at the top, "April, 1920." The

name of the month in this position not only facilitates reference but it also serves as a reminder that the transactions for each month must be entered in a separate section. Whenever the last monthly transaction is entered, the total to that point must be ascertained and a new page opened for the next month's transactions. There is no logical reason for selecting one month as a fiscal period but in the majority of businesses the calendar month is a convenient length of time for the accumulation of statistical figures of a convenient size for posting.

3. Terms

In the column headed "Terms" are entered the terms for cash discount applicable to each invoice. Cash discount must be carefully distinguished from trade discount, which is a subject to be discussed later. At this point all that need be said is that an allowance or a reduction in the amount of each invoice is made in accordance with the terms opposite the entry if such invoice be paid in the time specified. For example, the item of Johnson & Giles has terms of 2/10 n/30. This means that if the account is paid within ten days 2% may be deducted from it, but that it must be paid "net" in 30 days. It is desirable to have the terms of discount noted in both the purchase journal and the ledger account with the creditor.

In order to insure the payment of invoices within the discount period if a saving can be thus effected, various filing schemes have been devised to bring particular invoices to the attention of the management on the proper days.

PURCHASE

Date	Name of Creditor	Terms	L. F.	Amount	Merchandise	
					Dept. A	Dept. B
1920						
April 2	Johnson & Giles.....	2/10 n/30	701	$ 75.42	$.....	$50.00
2	Duggan & Hopkins.....	3/10 n/60	407	100.00	100.00	.....
2	Century Loft Company..	.....	500	250.00	.....	.....
3	Meecham & Baker, Attys	.....	510	50.00	.....	.....
3	N. Y. Central R. R. Co...	.....	515	8.49	.....	.....
3	Cooper & Henderson....	2/10 n/60	650	342.78	.....	.....
4	Blandy & Tanner.....	.....	690	12.73	.....	.....
	Total for April.....	.....	...	$ 3,786.31 V.	$949.80 10	$572.00 12

Form 7. Purchase Journal,

4. Analysis Columns

The columns to the right of the amount columns are provided so that purchases may be analyzed at the time of their entry into as many departmental and other accounts as are required. The number of columns and their uses in a particular book should depend partly upon the departmental divisions of the business, partly upon the classification of accounts desired in the general ledger and also upon the probable frequency with which entries will be made. If a debit to any one account is of

JOURNAL April, 1920

Purchases		Freight Inward	Office Expense	General Expense	Sundries		
Dept. C	Dept. D				Account	L.F.	Amount
$25.42	$.....	$....	$.....	$.....	.....	..	$.....
.....	.....	....	.....	.....	.....	..	.....
.....	.....	....	.....	.....	Rent	60	250.00
.....	.....	....	.....	50.00	.....	..	.....
.....	.....	8.49	.....	.....	.....	..	.....
.....	342.78	....	.....	.....	.....	..	.....
.....	.....	....	12.73	.....	.....	..	.....
$341.66 14	$807.12 16	$16.57 43	$214.98 47	$70.00 49	.....	..	$814.18 √

showing Purchases by Departments

rare occurrence, or if such debits during a month do not usually exceed three or four in number, there is no need for a separate column for that account. Such items may be entered in the sundries section at the extreme right of the above form, where the name of the account, the folio on which it appears in the general ledger, and the amount of the debit are shown. In general as few columns should be used as will give adequate distribution. As columns increase in number, the danger of entering amounts in wrong columns also increases.

5. Expense Accounts

The use of columns for expense accounts should be noted. While the title of the book seems to imply that entries should be restricted to purchases of merchandise, this is not so. Purchase items should include expenses such as freight inward, office expense, general expense, and sundries, for the reason that the purchase journal serves not only to analyze the purchases, but also to list the amounts payable to creditors. These obviously comprise payments for services, such as insurance, rent, etc., which cannot be classified as merchandise purchases, and for any assets bought for the needs of the business, such as equipment and office furniture. In brief, the purchase journal should contain a record of all expenditures on credit, and the debits to offset these credits should be so classified as to indicate the exact account affected.

6. Folio Columns

The folio column to the left of the first amount column indicates the page of the ledger on which the creditor's account appears. No folio columns are needed for the analytical debit columns because those columns are posted in total to the ledger accounts designated in each heading, as will be explained in the following section. The folio column in the sundries section indicates the ledger page of the particular account to be debited.

7. Monthly Closing

When the purchase journal is closed at the end of the month, all columns are added and their totals posted.

Since each item has been credited to an individual creditor's account, the total of the amount column need not be posted unless a controlling account for creditors is kept, as explained later. The only debits posted individually to accounts are those in the sundries column.

When posting the columnar totals at the end of the month the total merchandise purchases for Department A should be debited to an account so entitled and likewise the totals of the other departmental purchases. Freight inward, office expense, and general expense should be similarly posted to accounts with those titles. The most convenient way is to post directly from the purchase journal, indicating the folio under the amount at the foot of each column.

8. Summary Journal Entries

In many offices it is customary to journalize at the close of each month the various totals to be posted to the ledger accounts from books of original entry. If, for example, it was required to make a journal entry of the data shown on the accompanying form, the entry would be drawn up as follows:

Merchandise Purchases, Dept. A	$949.80	
" " " B	572.00	
" " " C	341.66	
" " " D	807.12	
Freight Inward	16.57	
Office Expense	214.98	
General Expense	70.00	
Sundry Debits Posted in Detail	814.18	
Sundry Credits Posted in Detail		$3,786.31

A journal entry of this kind summarizes and con-

denses the information covering all purchase transactions during the month and at the same time insures that the proper accounts are debited and credited. Postings, however, can be made as conveniently and with a saving in clerical work directly from the books of original entry.

9. Returned Purchases

In almost every business a certain portion of the goods purchased prove defective in some way or fail to meet the requirements. The entry recording a returned purchase should naturally be the reverse of that recording the original purchase, the general journal entry being a debit to the creditor and a credit to the Purchases account. Where a purchase journal is used, the returns may be handled in one of two ways. If few in number, they may conveniently be entered in the purchase journal, using red ink instead of black and posting the amount to the debit instead of to the credit of the creditor's account. The red ink figures in the distribution columns are to be deducted from the total of the black ink figures to obtain the net purchase figures. If returns are numerous, it is usually more convenient to enter them in separate sections of the purchase journal in black ink in the ordinary way. Where a separate section is used, the returns for each month should be totaled in the same way as the purchases for each month, but the postings of the returns should naturally be made in the reverse way. Where this method is adopted it is advisable to keep separate purchase returns accounts in the ledger, one for each department where the business is departmentalized. When the returns are entered

in red in the purchase journal, the postings to Returned Purchases account can be made conveniently by showing in the purchase journal two totals at the end of each month—one for the black figures representing purchases and one for the red figures representing returns.

10. Development of Purchase Journal

The simple form of purchase journal discussed in this chapter is suited to the needs of a business of moderate size, divided into not more than half a dozen departments. In a larger business with a great variety of purchase transactions the ruling shown in the example would prove inadequate for the classification and handling of many varied items, and the adoption of more advanced purchase forms and methods would probably be necessary. Such of those methods as are used in general trading or manufacturing accounting will be discussed in Volume II. The fundamental fact to be here noted is that purchases should not be entered in the general journal but should be recorded and classified on a separate journal of their own.

REVIEW QUESTIONS

1. How can additional columns be used effectively in the purchase book?
2. (a) Prepare a ruling for a purchase book to provide for total monthly charges to three material accounts and two expense accounts, and also to detail postings to sundry accounts.
   (b) Describe the method of posting from such a book.

CHAPTER XXII

THE VOUCHER SYSTEM

1. Inadequacy of Creditors Ledger

If purchases are made very frequently and from constantly changing vendors, and if each invoice is usually paid for in one amount, the opening of a ledger account for each vendor involves unnecessary clerical work and waste of ledger pages. In practically all of these accounts there will be one or two credits offset almost immediately by a debit from the cash book. Further, as accounts increase in number, it becomes difficult to keep them so that any one of them can be found quickly. If a bound book is used, one of unwieldy size is soon required. If loose sheets, the number of sheets increase so rapidly that the filing of sheets with closed accounts becomes a problem.

2. The Voucher System

The voucher system, with which this chapter deals, eliminates individual accounts with creditors by providing a record of payment in the purchase journal itself. The fundamental feature of the voucher system is the elimination of creditors' accounts. This is accomplished by providing space next to the credit item in the purchase journal in which to note its payment. Instead of posting the credit item to a ledger account, it remains in the purchase journal and, when paid, the fact of payment is noted in the space provided. All items not noted

as paid constitute the accounts payable. Thus the ledger feature is incorporated in the purchase journal, and the purchase journal then becomes a voucher register or record. A form of voucher record is shown on pages 244 and 245, recording the same transactions as those shown by the purchase journal in Chapter XXI.

3. Vouchers

In order to facilitate the handling of invoices which vary in size and shape, it is customary to have voucher covers to which invoices can be attached. A sheet 8 x 9 inches folded to 4 x 9 inches is a convenient size. On the back of the cover so as to be visible when the cover is folded, it is customary to print the name of the business and to provide spaces in which can be entered the name of the creditor, the date, the amount due, and the accounts to be debited. Form 8 is a simple example, reduced in size.

4. Operation of Voucher Record

As soon as invoices have been approved by those responsible for the receipt of materials and the checking up of prices and calculations, they are placed inside the voucher covers and on the outside is entered the information for which space is provided and the serial number of the record. The cover, together with the invoices and other papers supporting the creditor's claim, now constitutes a voucher and an entry is then made in the voucher record, or register as it is at times designated, in accordance with the information shown on the cover. The check in payment of the invoice, when returned canceled by the bank at the end of the month, should be

VOUCHER NO.....

HAYES AND BAYLIS
in favor of

.....

$..... .....191...

Paid by Check No.....

Merchandise Purchases—Dept. A.....	.....	....
" " —Dept. B.....	.....	....
" " —Dept. C.....	.....	....
" " —Dept. D.....	.....	....
Freight Inward.....	.....	....
Office Expense.....	.....	....
General Expense.....	.....	....
Rent	.....	....
Salaries	.....	....
.....	.....	....
.....	.....	....
.....	.....	....
.....	.....	....
.....	.....	....
Total	.....	....

Goods Received ..... Figures Checked .....

Prices Checked ..... Approved for Payment .....

Form 8. Voucher Folder

attached to the inside of each voucher, on top of the invoice or other papers. In this way the evidence of each creditor's claim and the fact of its payment are preserved.

After a voucher is entered on the record or register,

if payment is to be made immediately, a check is drawn and issued. Where payment is not immediate but observance of the terms of credit is necessary to secure a discount, the voucher should be filed away in a tickler file so that it will be automatically brought to attention at the proper time. Upon payment of the voucher the check is entered in the cash book and a notation is made in the payment column of the voucher record of its number and date.

5. Posting from the Voucher Record

With the difference that no postings are made to a creditors ledger, postings from the voucher record are handled in precisely the same way as from the purchase journal. A controlling account on the general ledger showing the total accounts payable controls the voucher record and makes the general ledger self-balancing. This controlling account is variously called "Accounts Payable," "Vouchers Payable," "Voucher Record," and "Audited Vouchers."

In the example given, the total of the amount column, $3,786.31, should be credited to such a controlling account. On the credit side of the cash book a column is provided in which individual payments of vouchers are entered. The total of this column should be debited to the controlling account at the end of the month. Payments should be noted in the voucher record from day to day and the voucher number entered in the cash book to perform the same function as the folio of a creditor's account.

If this procedure be followed, at the end of each month the controlling account will have a credit balance

April, 1920 — VOUCHER

Vo. No.	Date	Name of Creditor	Terms	Amount	Payment		Merchandise	
					Date	Chk. No.	Dept. A	Dept. B
607	2	Johnson & Giles.....	2/10 n/30	$ 75.42	4/11	7619	3.....	$50.00
608	2	Duggan & Hopkin....	3/10 n/60	100.00	4/12	7628	100.00	.....
609	2	Century Loft Company	.....	250.00	4/2	7595	.....	.....
610	3	Meecham & Baker, Attys.	.....	50.00	....	....	.....	.....
611	3	N. Y. Central R. R. Co.	.....	8.49	4/4	7600	.....	.....
612	3	Cooper & Henderson..	2/10 n/60	342.78	4/13	7635	.....	.....
613	4	Blandy & Tanner.....	.....	12.73	....	....	.....	.....
		Totals for April...	.....	$ 3,786.31 15	....	....	$949.80 10	$572.00 12

Form 9.

representing the liability for the accounts payable as shown by the voucher record.

6. Proof of Controlling Account Balance

At the end of each month the controlling account should be checked or proved with the open or unpaid items in the voucher record. The usual way of proving the correctness of the figures is to list the open items on an adding machine and, after the total has been checked as correct, to note thereon the numbers of the

RECORD

Purchases		Freight Inward	Office Expense	General Expense	Sundries		
Dept. C	Dept. D				Account	L.F.	Amount
$25.42	$.....	$....	$.....	$.....	.....	..	$.....
.....	.....	....	.....	.....	.....	..	.....
.....	.....	....	.....	.....	Rent	60	250.00
.....	.....	....	.....	50.00	.....	..	.....
.....	.....	8.49	.....	.....	.....	..	.....
.....	342.78	....	.....	.....	.....	..	.....
.....	.....	....	12.73	.....	.....	..	.....
$341.66 14	$807.12 16	$16.57 43	$214.98 47	$70.00 49	.....	..	$814.18 √

Voucher Record

vouchers unpaid. This list can then be pasted in a trial balance book as a permanent trial balance record.

7. Unusual Transactions

Vouchers are not always canceled by payments in cash. Sometimes a creditor's claim is settled in whole or in part by allowances or by discounts; or sometimes by the exchange of merchandise or assets other than cash. In such cases, with the exception of cash discounts, some entry is required other than one in the cash

book. If a voucher is canceled by a journal entry, the entry should be in the following form:

Vouchers Payable..... $.....
To account originally debited..... $.....

This entry has the effect of cancelling the one originally made in the voucher record. The entry should show the number of the canceled voucher and a notation should at once be made in the voucher record opposite the voucher number, showing the fact of cancellation and indicating the page of the journal in which the entry appears. The journal folio is entered in the space in the voucher record for the check number. The debit to the controlling account must be a separate item unless the journal is provided with a debit column for accounts payable. In that case the debit items may be entered in that column, the total of which is posted at the end of the month.

Instead of paying a voucher in full, payments are sometimes made in two or more instalments. In order to record these transactions it is necessary to enter each payment of cash in the voucher record, entering the date and check number for each instalment in small figures. The remaining or unpaid balance of such a voucher should then be noted in pencil, generally alongside of the payment column, so that in listing open or unpaid items at the end of the month this unpaid balance may be included.

The last example indicates a limitation of the voucher system in recording partial payments or payments on account. In such a case ledger accounts are preferable. Where, however, most of the creditors' claims can be handled by a voucher record, only a few requiring ledger accounts, ledger accounts may be

opened for these few. In other words, a combination of the two systems can be employed.

8. Voucher Checks

Because of the risk of loss, no voucher should be sent to a creditor to be receipted and returned. It is desirable, therefore, in some way to identify on the check itself the voucher which the check pays. Such a check is known as a voucher check. In its simplest form it consists of an ordinary check on which is stamped sufficient information to identify the voucher. A convenient form for this purpose is the following, for which a rubber stamp can be made:

> Indorsement of this check will constitute a receipt in full for the following items:
>
> Your invoice dated..... 19..
> Our voucher No. ..... covering
> .....
> .....

Instead of a rubber stamp a special form of check may be used which has printed upon it much the same information as indicated.

REVIEW QUESTIONS

1. State briefly the uses and limitations of the voucher system.
2. (a) Give headings for a voucher record suitable to any business with which you are acquainted.
   (b) Describe the method of posting from such a book.

CHAPTER XXIII

MISCELLANEOUS SALES MATTERS

1. Analytical Form of Sales Record

The same observations apply to the division of sales into departments as are applicable to the purchases of a business. To secure the desired classification of sales, as many columns must be ruled in the sales journal as there are classes of goods, the sales of which are to be shown separately on the books. The form presented on pages 250 and 251 is adequate for a moderate sized business where the transactions are not especially complicated. The illustrative entries and the following comments will explain its underlying feature so that modifications of the form may be introduced to meet varying conditions.

2. Monthly Period; Terms and Folios

The desirability of securing a monthly total of purchases has been emphasized, and the same is applicable to sales. The terms of sale are as important as the terms of purchase and should be treated in the same way in the sales journal as in the purchase journal. Customers frequently deduct discounts to which they are not entitled, and, unless the terms of sale are clearly entered in the journal and noted in the customer's account, an unauthorized deduction for discount may be overlooked. The use of the folio columns is identical with that in the purchase record and requires no further comment.

3. Sales Number

The sales may conveniently be numbered and entered numerically. This provides reasonable certainty that none of them will be overlooked. Where the records are not properly designed and operated, it is not uncommon to find a sale completely omitted from the books, resulting often in a loss of the amount involved in the transaction.

4. Charge Sales

The items in the charge sales column are debited individually to personal accounts with customers. Offsetting credits are handled in the same way as those in the purchase journal. The total of each column relating to department sales is credited to a Department Sales account and the folio is noted under the total to indicate the fact that it has been posted. In the sundry sales section, the use of which will be discussed later, items are credited individually to their proper accounts, so that the total of that column does not need to be posted. A verification of the correctness of the additions in the sales journal can be obtained by ascertaining that the total of the charge and cash sales columns equals the sum of the totals of all the other columns.

5. Cash Sales

In the illustrative form sales are primarily classified under the heads of "cash" and "charge" sales, this being a convenient division for those businesses in which cash sales are made over the counter. To determine the total sales of each department, it is necessary to combine cash and charge sales. Cash sales are entered in the sales

April, 1920 SALES

Sales No.	Date	Name	Terms	L. F.	Amount of Sale	
					Charge	Cash
	1920					
782	April 1	Burton & Co.....	2/10 n/30	201	$115.00	$.....
783	1	Blaisdell & Anson.....	"	217	281.64	.....
784	1	Jenson & Bro.....	2/20 n/60	207	996.37	.....
785	1	Cash Sales for Day.....	.....	√	.....	196.11
786	2	Wilson & Babage.....	Net	241	52.58	.....
		Totals for April.....	.....	...	$4,017.82 √	$831.96 √

Form 10. Sales Journals

journal and distributed in the columns provided therein, because to provide such columns for their analysis in the cash book, as would be necessary if cash sales were to be analyzed separately, would entail duplication of effort. Accordingly, to avoid this duplication, cash sales are entered in the sales journal and distributed in the columns provided therein.

It is important, however, to enter the total of the cash sales in a separate column. If a controlling account for accounts receivable were maintained, as will be explained in Chapter XXIV, it would be necessary to secure the total of the charge sales for posting to that account; but

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Dept. A	Dept. B	Dept. C	Dept. D	Sundry Sales		
				Article	L.F.	Amount
$115.00	$.....	$.....	$.....	.....	..	$.....
.....	250.00	.....	31.64	.....	..	.....
.....	.....	996.37	.....	.....	..	.....
47.18	32 09	100.50	16.34	.....	..	.....
.....	.....	.....	.....	Containers	98	52.58
$1,092.34	$916.11	$888.71	$1,900.04	.....	..	$52.58
100	102	104	106			V

showing Sales by Departments

even if no such controlling account is kept, time and effort will be saved by listing the total of the cash sales in a separate column. It will be noticed that an entry is made only of the total cash sales for the day. It is unnecessary to duplicate the individual items of such sales in this book, as they already appear in the cash records.

The total of the cash sales column may be debited at the end of the month to Cash Sales account in the general ledger. This debit and those to individual customers offset the credits to the various sales accounts. If such a Cash Sales account be used, it should be credited at the end of each month with the total cash

collections from cash sales. This latter figure can be secured from the cash receipts record which should be provided with a separate column in which cash sales may be entered. It is evident that the Cash Sales account will have no balance at the end of the month because no sale is entered as a cash sale unless the cash is at once received; consequently, the entries for the daily totals made in the sales journal will exactly equal the sum of the collections entered in the cash record. Thus the debit to the Cash Sales account from the sales journal will exactly equal the credit to that account from the cash book. From this it follows that the Cash Sales account in the ledger may be omitted. In that event, neither the debit from the sales book nor the credit from the cash book would be posted.

6. Sundry Sales

Under the head of "sundries" are included items which cannot be readily classified under the department headings. In the illustrative example a sale of containers is recorded. Any sale, even of a fixed asset, can usually be recorded most conveniently in the sales journal because this is the logical medium for posting the sale to the debit of the purchaser. Sales of such items should not be credited to the sales accounts because these accounts are designed to show the regular trading sales in each department. The credit for each miscellaneous or sundry sale should, of course, be made to the account which records the asset sold.

7. Sales to Proprietor

When merchandise is withdrawn for the personal use

of the proprietor the accounting for such merchandise should be so handled that trading results will not be affected by such withdrawals. The easiest way to record such personal use of merchandise is to bill it to the proprietor in the regular way. If, however, the proprietor insists on withdrawing goods at cost, the most accurate method of recording the withdrawal is to treat it as a credit to purchases. Such merchandise should not be credited to sales because it is not sold at the usual selling price and the gross profit will be understated if it be so included. If these sales are infrequent, they may be passed through the sales journal, since their effect upon the gross profit will be negligible.

8. Containers

Containers of all kinds, boxes, barrels, bags, etc., frequently present an annoying accounting problem. Problems connected with their proper accounting under peculiar circumstances will not be considered in this volume. The simplest case, which is the one presumed in the illustrative entry, is when a container is sold outright—usually to a junk dealer. In this case, a Containers account would be credited with the amount realized on such sale. Care should be exercised not to include sales of containers in the general sales.

9. Freight Outward

Where the invoice to a customer includes a definite charge for freight outward, the goods being sold f. o. b. store, it is obvious that the freight should be credited not to the Sales account, because it does not represent a sale of merchandise, but to a separate account, Freight

Outward. A column may be provided in the sales journal for such freight and the amount thereof entered in that column.

10. C. O. D. Sales

A C. O. D. sale must be delivered before the cash is received and considerable time may elapse between the shipment and the receipt of the money to be collected. Consequently, some method needs to be provided to record such sales so that they will not be overlooked. When numerous, a column should be allotted to them similar to that for cash sales and a column in the cash book should also be used for collections. Consequently, a C. O. D. sales account will be debited from the sales journal and credited from the cash book, the balance being a debit representing the outstanding and uncollected shipments.

11. Returned Sales

If returned sales are few in number, they may be entered in red in the sales journal. In such case the customer's account will be credited instead of debited, if a charge sale be returned. If a cash sale be returned the figure may still be entered in red in the cash sales column and the same figure should be charged to cash sales on the credit side of the cash book. Where red figures are used, they may be deducted from the total of the black figures in the distribution columns or those columns may show two totals—one in black for the sales and one in red for the returns. The posting and other bookkeeping procedure in connection with returned sales is identical with that described for re-

turned purchases except, of course, that the debits and credits for a returned sale will be the reverse of those for a returned purchase. Where returned sales are numerous, a separate journal or a separate section of the sales journal should be provided for their entry.

12. Special Forms and Methods

In a large business where transactions are complicated, the form of sales journal herein described may be inadequate. Special forms for the recording and the billing of customers' orders as filled must be provided and suitable methods of bookkeeping in connection with sales should be designed. In Volume II of this series such special methods and forms will be described.

REVIEW QUESTIONS

1. How can additional columns be used effectively in the sales book?
2. (a) Prepare a ruling for a sales book to provide:
   Total monthly postings to three goods accounts.
   The separation of cash sales from charge sales.
   (b) Describe the postings from such a record.

Part V
Miscellaneous Accounting Topics

CHAPTER XXIV

CONTROLLING ACCOUNTS

1. Introductory

A controlling account is kept in the general ledger and is one which controls, i. e., summarizes, a number of other accounts usually kept in a separate ledger, by showing in its balance the net amount of the balances of all the controlled accounts. These latter are known as subsidiary accounts, and the ledger in which they are kept is called a subsidiary ledger. The use of a controlling account presents no difficulties provided the reason for its existence is understood, and no other expedient in double-entry bookkeeping is so fundamentally useful.

2. Arrangement of Accounts

Instead of accounts being arranged indiscriminately, regardless of their classification, it is, as explained in Chapter VI, far more convenient to arrange them so that in the trial balance the accounts that are grouped together will indicate in a general way the vital facts concerning the business. Asset accounts other than accounts receivable should be in one section of the ledger, expense accounts in another, income accounts in another, accounts payable in still another, and other accounts should be similarly grouped.

It is evident that all accounts in the ledger must be considered in the trial balance, regardless of the scheme

of classification by which ledger accounts are grouped. If a single account or any group of accounts were omitted from the trial balance, equilibrium would be impossible. As heretofore stated, a Cash account is not always kept in the ledger, in which case the amount of cash as shown by the cash book must be included in the trial balance. The safer and better practice, however, is to make the ledger self-balancing by including in it cash and all other accounts.

3. Advantages of Controlling Accounts

In a large business, the inconvenience and risk of error due to having a great many accounts in one ledger may be avoided by dividing the accounts into various groups, opening a separate ledger for each group and substituting in the general ledger one controlling account for each group of accounts removed to a subsidiary ledger.

The advantages of controlling accounts may be enumerated as follows:

1. They make possible the use of loose-leaf subsidiary ledgers. Where the customers of a business are frequently changing and the sales to each are infrequent, it is generally better to keep their accounts in a loose-leaf ledger. By this means accounts which are closed may be taken out of the ledger and filed in a transfer binder, and those which remain can be grouped alphabetically, geographically, or by departments. The form of loose-leaf ledger depends entirely upon the requirements of the particular business in which it is to be used. Cards are frequently employed and prove satisfactory, except for the risk of removal. If card ledgers are used, the credit

department, salesmen, and all other persons in the organization, including the administrative heads, must be cautioned not to remove cards from the ledger for any purpose whatever. If a statement of a customer's account is needed to facilitate correspondence with him, the statement should be provided by the bookkeeping department but the customer's ledger card should not leave the file.

2. Controlling accounts facilitate the division of work among several employees. It is unusual to find a business where all the accounting can be done by one bookkeeper or clerk. When subsidiary ledgers are employed it becomes possible to assign bookkeepers to different ledgers, thereby facilitating the work and helping to fix the responsibility for errors.

3. Controlling accounts make possible the quick preparation of financial statements. When the general ledger is once in balance it may be assumed to be correct even before subsidiary ledgers are balanced. Statements of financial condition can thus be prepared without waiting for the proof of accounts receivable or accounts payable or other subsidiary ledgers. Moreover, statements can be sent to customers as soon as the subsidiary ledger for accounts receivable is shown to be correct even though the general ledger may be out of balance.

4. The use of controlling accounts is a great aid in localizing errors revealed by a trial balance. As each subsidiary ledger is proved to be in agreement with its controlling account, it may at once be eliminated in a search for a difference. When the difference is finally located in one ledger, either general or subsidiary, the

search may be confined to that specific section of the work.

When the accounts in a ledger run to several hundred or more, as is frequently the case in a business of any size, the task of drawing off a monthly trial balance becomes burdensome. If at the first attempt it does not balance, the search for the "difference" is likely to be laborious and irritating. If more than one bookkeeper is employed, to fix responsibility for errors becomes increasingly difficult and the whole of the bookkeeping staff may be penalized by overtime work for the error of an individual employee. Statements to be rendered to customers and financial statements for office use cannot safely be prepared until the ledger is in balance, and in other ways a trifling clerical error may seriously disorganize the routine of a large office. Current work is sometimes so delayed by trial balance difficulties that it becomes exceedingly troublesome and entails much overtime work to bring the records up to date.

4. Opening of Controlling Accounts

Since a controlling account represents in its balance the net amount of all balances of accounts in a subsidiary ledger, it is obvious that the way to open a controlling account is to withdraw from the general ledger the accounts that are to be placed in a subsidiary book, substituting in their place the one controlling account. By so doing the general ledger is left in balance, although the number of accounts therein is reduced by those transferred to the subsidiary ledger. The opening of a controlling account should invariably be made by a journal entry.

5. Journal Entry to Open Controlling Accounts

The journal entry required to open a controlling account may be made in a two-column journal, but it is better to have a columnar journal with a debit and a credit column for each ledger used. If a general ledger, an accounts payable ledger, and an accounts receivable ledger are used, a six-column journal should be employed with two columns for each ledger. The use of such journals is explained in Volume II.

In a two-column journal the entry to open a controlling account should show a debit or a credit to the controlling account which equals the net amount of the debit and credit balances in the detail accounts which are to be transferred. Assume for illustration the opening of a controlling account for accounts receivable, some of which have credit balances, due to overpayments and credits for returned sales. The first step in the preparation of the opening journal entry is to determine the exact balances of all customers' accounts to be transferred. An entry should then be made debiting a controlling account which may be called "Accounts Receivable" with the net of all the balances, debiting also any customers' accounts which contain credit balances and crediting all other accounts with customers. The posting of such a journal entry to the accounts in the general ledger needs no explanation. The final result is to eliminate from the general ledger all customers' accounts and to substitute a single controlling account in their place.

The subsidiary accounts receivable ledger should now be opened and an account provided therein for each customer as recorded in the journal entry. The same

journal entry may be used for posting to the subsidiary ledger, care being taken to debit each customer's account in that ledger with the same amount that was credited to his account in the general ledger. Although the customers' accounts in the general ledger may be numerous, the journal entry as suggested above should nevertheless be made. Balances ought not to be transferred from one ledger to another except through the medium of the journal. The reason for this is that if the subsidiary ledger accounts should later prove to be out of balance, there will be no certainty that the opening balances were correctly transferred.

6. Devices to Save Work

In order to avoid the task of writing each customer's name and balance in the journal—a task of considerable size if such accounts run into hundreds—the following procedure is suggested: The balances of the accounts to be transferred may be listed on an adding machine. The correct total will then be assured and the adding machine list may itself be pasted in the journal. The name of each customer can then be noted on the adding machine list opposite to the balance in his account, and postings can be made both to the credit of the customer's account in the general ledger which is to be closed and to the debit of his account in the new ledger which is to be opened. Only a sufficient notation need be made on the list to identify the account. This practice saves time, insures the correctness of the addition, and economizes space in the journal since the adding machine slip may be cut into proper lengths so that three or four widths may be pasted on one journal page.

7. Current Entries

The operation of controlling accounts requires that in each book of original entry a column be allotted to each controlling account. The individual amounts to be debited or credited to separate accounts in the subsidiary ledger are entered in their proper columns and then added and posted in total at the end of the month to the controlling account affected. If each item which is posted to an account in a subsidiary ledger were also to be posted in detail to the controlling account, practically no advantage would be gained by having such an account and much needless duplication of work would result. Accordingly the postings to controlling accounts from each book of original entry should be in monthly totals, care being taken to include in those totals every item posted in detail to any account in the subsidiary ledgers. It is obvious that the balance of the controlling account will not agree with the balances in the subsidiary ledger unless every item entering into the subsidiary ledger is in some way included in the controlling account and vice versa.

8. Posting to Subsidiary Ledgers

In the discussion of the cash book in Chapter XXVI, a column on the debit side of that book for accounts receivable and one on its credit side for accounts payable will be pointed out as necessary to utilize controlling accounts.

To take accounts receivable as an example, every receipt of cash from a customer should be credited from the cash book to his individual account in the accounts receivable ledger. At the end of each month the total

of the accounts receivable column can then be posted to the credit of the controlling account. By this means every item which has been credited to an account in the subsidiary ledger will, in effect, by being included in the total, be credited to the controlling account.

9. Accounts Receivable Ledger

It will be remembered that the sales book suggested in Chapter XXIII contained a column for charge sales. Continuing the example of accounts receivable, every item entered in that column of the sales book should be debited to a customer's account in the accounts receivable ledger. Since the total of the charge sales column at the end of each month is to be posted to the debit of the controlling account in the general ledger, it is evident that every item posted to the debit of any account in the subsidiary ledger is in effect posted to the debit of the controlling account.

Where journal entries affecting controlling accounts are numerous, two columns of the journal should be provided for each controlling account, as explained above. Accounts receivable are frequently affected by journal entries for unusual allowances which cannot conveniently be handled in a return sales book, as suggested in Chapter XXIII. Every item which is entered in the journal to the debit or credit of an account receivable should be posted to such account in the subsidiary ledger and the total of each of the columns in the journal in which such items appear should be posted at the end of each month to the debit or credit of the controlling account as the case may require.

10. Accounts Payable Ledger

The purchase book discussed in Chapter XXI contained a column for amounts due to individual creditors. When a controlling account is maintained for accounts payable, the individual postings and the posting of the monthly total from the purchase book are made in the same way as similar postings from the other books.

11. Frequency of Posting; Subsidiary and General Ledgers

All detail postings, from whatever book of original entry, which affect individual accounts in subsidiary ledgers, should be made daily, so that if a customer or a creditor desires to know his balance it may be given to him instantly. The posting at the end of the month should be confined solely to the total affecting the controlling account. From this it follows that during the month the controlling account will not give any information disclosing the condition of the subsidiary ledger. It is not necessary that it should. The advantages of a controlling account lie in the agreement with its subsidiary ledger at the end of each month.

12. Unusual Entries in Controlling Accounts

In the foregoing description of the use of controlling accounts only the ordinary and customary transactions have been considered. Some entries, however, are unusual and a column for the collection of their monthly totals cannot always be conveniently provided. Such transactions must be posted in detail to the controlling account at the same time that the posting is made to the individual or subsidiary account.

An example of such an unusual transaction would be the receipt of cash from a creditor to adjust an overpayment. Such an item should appear on the debit side of the cash book and would be posted to the credit of the individual creditor's account. As ordinarily there is no column on that side of the cash book for accounts payable, the item must at once be credited to the controlling account. Failure to observe this simple requirement would, of course, throw the books out of balance.

13. Monthly Trial Balances

If postings have been properly made to controlling accounts, the general ledger will be in balance at the end of the month. Each subsidiary ledger should then be proved by listing its balances and seeing that their net amount agrees with the balance in the controlling account. The expression "net amount" of these balances is used advisedly. While most of the balances of a subsidiary ledger are on the same side—all credits or all debits—occasionally a balance is found on the opposite side. For example, a customer's account may contain a credit balance, or that of a creditor may show a debit balance because of some unusual transaction. Such balances must, of course, be deducted from the sum of the usual balances in order to determine the net balance which will agree with that of the controlling account. A credit balance in a customer's account could result from an inadvertent overpayment by him or from a credit for returned goods which had been accepted either because the goods were defective or because the customer's good-will could be preserved only by allowing the credit. A debit balance in an account payable could re-

sult from an overpayment or from a return of goods purchased after they had been paid for.

The subsidiary ledger, therefore, is not self-balancing, practically all of its balances being on one side. To call a list of the balances in a subsidiary ledger a "trial balance" is hardly accurate in the strict sense of this term, although it is customary in accounting terminology to designate such a list as a trial balance.

14. Controlling Account in Subsidiary Ledger

A subsidiary ledger may be made self-balancing by the following expedient: Therein an account can be kept which will be exactly the reverse of its controlling account in the general ledger. The same monthly postings and the same incidental postings for unusual transactions which are made in the controlling account in the general ledger may at the same time be made in reverse —debits for credits and vice versa—in this new account in the subsidiary ledger. Such an account could be called a controlling account for the general ledger. Its operation makes the subsidiary ledger self-balancing.

It is, however, rarely advisable to use such an account when all the bookkeeping is done in one office, as no purpose is served that is not equally well served by the controlling account on the general ledger. The practice has one element of danger in that it gives the bookkeeper who is responsible for the subsidiary ledger an opportunity to force his balance; which means to report falsely in order to make his ledger appear to be in balance. A bookkeeper in charge of a subsidiary ledger should be required to report its trial balance—using the phrase as explained in the preceding section—in igno-

rance of the figure with which it must agree. Thus he has no means of knowing in advance whether or not his trial balance is correct and there will be no temptation to misstate his balances to avoid overtime work.

15. Extension of Controlling Account Principle

Controlling accounts are most commonly used for accounts receivable and accounts payable. They may, however, be employed in any case where it is desired to relate one ledger definitely to another which must be self-balancing. Controlling accounts thus are used in branch office accounting where ledgers kept in different offices form integral parts of the accounting system; they are used in cost accounting where separate ledgers are kept to show the progress of work in the factory; and another example of their use is in connection with private ledgers.

REVIEW QUESTIONS

1. What general rule should govern the order in which the accounts should be arranged where only one ledger is operated in a small business?
2. Does any advantage attach to the employment of more than one volume for the ledger of a business requiring only one bookkeeper? Give reasons.
3. (a) What is the purpose of controlling accounts?
4. What do you understand by a self-balancing purchase ledger? Describe fully the method of keeping it.
5. From the data presented in the illustrative proposition in Chapter XVI, construct a creditors' controlling account, proving the figures of same against the ledger accounts as there presented.
6. Rule a cash book to provide for controlling accounts of debtors and creditors.

CHAPTER XXV

TRADE DISCOUNT AND CASH DISCOUNT

1. Discounts in General

A discount is an allowance or rebate to reduce the nominal price of anything. Commercial discounts may be divided into two main groups. The first consists of deductions made from list or catalogue prices when an article is sold. Such discounts are really a part of the bartering or trading which precedes the fixing of the real or actual price. Trade discounts come within this classification.

The second kind of discount is an allowance for prompt payment after the purchase price has been definitely fixed and the sale made, and is known as a "cash discount." The rebates said to have been allowed by railroads to shippers, which have been held to be illegal, belonged to the second general class. In business many items are allowed in reduction of the price of goods sold which are not strictly cash discounts. Such items, although strictly cash discounts, are commonly designated as "allowances."

2. Trade Discount

Trade discounts are allowed as a reduction from a catalogue or list price, either to avoid printing new catalogues whenever prices fluctuate or to provide a ready means for fixing prices in unusual cases. An example of the latter procedure is that of a sale to a customer

who is given an exceptionally favorable price either because of his credit standing or because of the volume of his business.

3. Method of Stating Trade Discount

Trade discounts are usually cumulative. This means that they consist of two or more percentages the first of which is deducted from the catalogue or list price, the second from the balance left after the deduction of the preceding percentage, and so on. For example, a trade discount may be expressed as 15-10-7. This would be calculated by first deducting 15% from the list price; then 10% from the balance; and finally 7% from the second balance. Assuming the list price to be $100, the final selling price would be $71.15.

Because these percentages are cumulative, the order in which they are stated does not matter. A discount of 50-30-10 equals that of 10-30-50 or any other order of these rates.

4. Quick Methods of Calculation

In the example given of 15-10-7, these rates are known as "percentages off" because they are to be taken off the list price. The remaining percentages of 85-90-93 are known as "percentages on." The problem in calculating any trade discount is, of course, to arrive at the final price, which will be a certain percentage of the list price. If the discount were but one percentage, for example 15%, the selling price would be 85% and it could be determined by calculating the "percentage on" of 85. If, however, there are three percentages to be deducted, the final "percentage on" can be determined

by multiplying together the three percentages on and using the product as the final percentage on. In the example given those percentages are 85-90-93. The product of these three percentages is 71.145 and this is the final "percentage on" which will give the actual price. Assuming the list price to be $100, the actual price will be $71.15 as stated in the preceding section.

Where the transactions involving trade discount are numerous, tables can be prepared showing the final percentage on for all the usual combinations. Such a table consists of a series of columns giving the usual discount rates and showing in one column the final percentage on, by use of which the actual price can be calculated after the various percentages have been deducted. Such a table makes possible the quick and accurate checking of invoices to which trade discounts are applicable.

A single discount, if it be a factor of 100, can be calculated most quickly by dividing the list price by the other factor. For example, if the discount is $12\frac{1}{2}\%$, it can be more quickly calculated by dividing by 8 than by multiplying by $12\frac{1}{2}$ and dividing by 100.

5. Factors and Reciprocals

In order to understand the preceding rule, some reference to elementary arithmetic must be made. A factor is one of two or more quantities which when multiplied together produce a given quantity. For example, the factors of 24 are 6×4, or $2 \times 3 \times 4$, or $2 \times 3 \times 2 \times 2$. If two factors multiplied together produce 1 they are called reciprocals. Examples of these are .5 and 2; .125 and 8. In the case of reciprocals, multiplying by one of them is equivalent to dividing by

the other. This can be demonstrated as follows by applying the reciprocals .5 and 2 to the quantity 8:

$$\begin{aligned} 8 \times .5 &= 4 \\ 8 \div 2 &= 4 \\ 8 \times 2 &= 16 \\ 8 \div .5 &= 16 \end{aligned}$$

The same rule holds true if the reciprocals produce 100 instead of 1, the only difference being in the placing of the decimal point. Thus, if the discount rate is a factor of 100, the discount can be calculated by dividing by the other factor.

6. Incidental Use of Reciprocals

Reciprocal tables showing all reciprocals up to several decimal places can be purchased. Such tables can be conveniently used in conjunction with an adding machine upon which multiplication can be easily performed but with which it is difficult to divide. Where much division has to be done, as in calculating percentages on statements, the result can be quickly obtained by finding in the table the reciprocal of the divisor and multiplying by that amount.

7. Trade Discount in the Accounts

Trade discount does not enter into the bookkeeping and accounting of a business because it is merely a means of fixing the actual price of the thing which is purchased or sold. Once the actual price is fixed, the entries in the books and accounts should show only that price. A trade discount is merely a matter of bargaining between buyer and seller which precedes the actual fixing of the selling price. Care should be taken, how-

ever, to make sure that the discounts are really trade discounts and not cash discounts, because the latter must be accounted for in the books of account.

8. Cash Discounts

A cash discount is an allowance for the payment of an item before it is finally due. If, for instance, goods are sold on the terms of "2/10 n/30," this implies that they must be paid for at their billed price (net) in thirty days, but if they are paid for in 10 days 2% may be deducted from such price. The nature of cash discounts needs now to be considered in order to determine whether they should be regarded as income or expense or as adjustments of invoice prices.

Opinions vary as to whether cash discounts when taken should be regarded as a reduction of the price or as losses to the seller and gains to the buyer who is financially able to secure them by prompt payment. The ostensible reason for allowing cash discounts is to induce prompt payment and thereby to secure working capital. While it is true that sellers are sometimes obliged to give them rather because of trade custom than because they need working capital, nevertheless the fundamental reason for allowing such discounts seems to be the desire to secure capital. Further, a cash discount is not secured if the payment is not made within the time limit, and it seems illogical to hold that the price of an article depends upon the time in which it is paid for. Consequently, it is more reasonable to consider cash discounts as expenses or income belonging to the financial end of the business than as adjustments of prices. Cash discounts invariably exceed ordinary interest and there-

fore it is usually advisable to borrow money, if necessary, in order to take advantage of them.

9. Basis for Calculating Cash Discount

A cash discount should be deducted from the amount of the invoice paid and, since it is a premium for prompt payment, it should be calculated only on the amount paid. Assume a purchase of $180 subject to a 2/10 discount, and a return within 8 days of goods invoiced at $50, thus leaving $130 due. In settling the account the discount of 2% should be calculated on $130 and not on $180.

This procedure seems elementary and obvious, yet arguments have been advanced in favor of deducting discount on $180 and such is the practice in many cases. In justification, it is maintained that if the return be made after the settlement less discount, credit should be given for the gross amount of goods returned and not for the $50 less 2%. In the example given, if the entire bill of $180 were paid subject to discount, the payment would amount to $176.40. If merchandise invoiced at $50 be then returned, the buyer should not claim credit for $50 because of the fact that he has in effect paid only $49.

The force of this argument is weakened by the probability that most merchants would allow a credit of only $49 under these circumstances. But even a credit allowance for the gross amount would not be an argument in favor of calculating the discount on $180 in the first assumed case. A buyer is entitled to discount only on the money paid because the discount is given as consideration for prompt payment.

The suggestion presents itself that unscrupulous buyers might secure discounts on the total invoice instead of on the net by withholding returns until after payment. Such practice is not likely to become common because most buyers would not care to make the necessary outlay and then wait for the credit until the seller saw fit to give it.

10. Bonus on Total Purchases

Sometimes a bonus is allowed on the total amount of purchases made during a given period of time. Such a bonus should be calculated on the gross amount and not on the net after reduction by cash discount. A bonus is an adjustment of the purchase price and not a reward for prompt payment.

11. Bookkeeping for Cash Discounts

There are three standard methods of recording cash discounts. The first is to pass them through the general journal; the second is to show them in the cash book as a rebate, i.e., on the opposite side to the receipts or payments to which they relate; and the third method is to use discount columns in the cash book. These methods will now be illustrated.

12. Journalizing Cash Discount

If a sale of $100 on a 2% cash discount basis were made, the original entry should be a debit to the customer and a credit to Sales. When later the customer pays $98, it is evident that he must be credited with $100, of which $98 is cash and $2 is discount. The credit of $98 is made through the cash book in the usual way,

while the discount of $2 is passed through the journal by means of the following entry:

Discount on Sales	$2.00	
To Customer		$2.00

On the buyer's books, conversely, at the time of purchase the Purchases account should be debited and the seller credited. When payment is made the seller's account must be debited with $100, $2 of which is discount. The debit of $98 should be made from the cash book and that of $2 through the journal, by the following entry:

Seller's Account	$2.00	
To Discount on Purchases		$2.00

There are several disadvantages in this method of handling discounts. It is evident that when purchases and sales are numerous, a considerable number of entries have to be made. Moreover, the risk of error in calculating and posting is greatly increased because of the fact that cash is entered in the cash book and discount in the journal so that comparison of the two amounts is inconvenient at the time of the entries. The drawback of journalizing discount in the way just described led to the adoption of the following method.

13. Cash Discounts Recorded as Cash

In the example given, entries in the seller's cash book might be made as follows: Although only $98 is received, $100 might be entered on the debit side of the cash book and at the same time $2 on the credit side as a payment. The credit of $100 would then be made to the customer's account and the debit of $2 to Discount on Sales. The buyer could treat the discount similarly by

showing on his cash book a payment of $100 chargeable to the seller, and a receipt of $2 to be credited to Discount on Purchases, although as a matter of fact there has been merely the one payment of $98 made by the buyer.

This method, though more convenient than journalizing, is subject to the objection that the cash book debits will exceed the actual cash receipts and the credits the actual cash payments. If receipts and payments shown in the cash book do not correspond with the actual amounts paid into and withdrawn from the bank, the verification of the cash book figures by comparing them with those of the bank statements cannot be readily made. The importance and method of making this comparison are discussed in Volume IV of this series. Here it is merely necessary to state that because of this difficulty modern practice usually follows a third and improved method of recording cash discounts, described below.

14. Cash Book Column for Discount

The most convenient way of recording cash discounts is to provide a column on each side of the cash book which in effect contains journal entries for the discount. The first column on the debit side may be used for net cash received, the second for discount on sales, and the third for accounts receivable. In the example given $98 would be entered in the net cash column, $2 in the discount on sales column, and $100 in the accounts receivable column. The credit side of the cash book should be ruled in the same way, the first column being for the net payment, the second for discount on pur-

chases, and the third for accounts payable. The buyer in the example given would enter $98 in the net payment column, $2 in the discount on purchases column, and $100 in the accounts payable column.

This method has two advantages. In the first place it brings the discount and the net cash together on one line in one book so that the amount can be verified by mere inspection. There is thus practically no danger that the discount will be incorrectly calculated or posted to a wrong account. A further advantage is that the discount columns can be added and the total of each posted as one amount at the end of a month, thus eliminating the postings in detail which are required under either of the two preceding methods.

The posting of the totals of the discount columns in the cash book is usually made directly from the cash book, the folio being entered under the total which is posted. Some bookkeepers prefer to carry the total discount on sales over to the right-hand page and, conversely, the total discount on purchases over to the left-hand page—to be posted from those sides rather than from the original columns. The reason for this is to secure consistency by posting all items from the debit side of the cash book (with the exception of net cash) to the credit of accounts, and all items from the credit side (except cash) to the debit of accounts. Such cross entries, however, are rarely advisable.

15. Showing of Discount on Financial Statements

Financial statements should show the discounts on purchases and sales. If the discounts are regarded as price reductions, then it would be desirable to show the

gross amounts of purchases and sales and also the amounts of the discounts, deducting the latter from their respective gross amounts and extending the net in each case. If the more commonly accepted view is held that cash discounts do not affect the prices at which things are sold, it is advisable to show cash discounts as an expense of financing the business or as an income resulting from the profitable use of ready cash. This point will be more fully discussed in Volume IV.

16. Provision for Discounts in the Closing Entry

In preparing the adjusting entries at the end of a fiscal period, it is necessary to provide for all elements affecting profit and loss which are not already recorded in the accounts. A question frequently raised is whether provision should be made for cash discounts which customers are expected to take and which the business expects to receive on its own accounts payable. Where the practice in a particular trade is almost invariably to take discounts, the argument seems sound that in a balance sheet accounts receivable and payable should be reduced by the cash discounts which are expected to be taken on both sides. But when such reductions are made it does not necessarily follow that the offsetting adjustment should be to expense and income accounts for the period ending with the balance sheet date. If the reduction of accounts receivable is debited to Discount on Sales, and the reduction of accounts payable is credited to Discount on Purchases, although neither of these discounts has yet been taken, the effect would be to show the discounts which are expected to be taken in a succeeding period as expense and income of the current

period. Since the discount does not become effective until it is taken, and the right to take it is lost if payment is not made within a specified time, it seems more logical to treat cash discounts as income or expense of the financial period in which they are actually taken. Consequently, if accounts receivable and payable are reduced by anticipated discounts, the offsetting entries should not be to current cash discount accounts but to suspense accounts raised temporarily and closed at the beginning of the next fiscal period.

17. Desirability of Abolishing Cash Discounts

From time to time, associations of credit men have considered the desirability of abolishing cash discounts. Despite all attempts to stop unwarranted deductions, many business houses still deduct discounts to which they are not entitled. This is done on the assumption that the seller will not run the risk of losing a customer by insisting on the exact discount terms quoted. This questionable practice is due to the fact that the right to deduct the discount is given to the buyer, leaving him free if he does not consider the moral aspect of the transaction, to take advantage of a discount to which he is not entitled.

Many credit men believe that this right should be taken from the buyer and given to the seller. Instead of allowing the discount to be deducted by the buyer, the seller should be required to return a bonus equal in amount to the cash discount, if the buyer pays within the discount period. There is a general feeling that sellers could be trusted to do this in view of the pressure which could be brought to bear upon them by

threatened litigation. A seller who failed to comply regularly with such a practice would soon lose his customers; and, as sellers are as a rule commercially more stable than buyers, little risk seems to be attached to the working of the system. The additional cost to the seller in clerical labor would probably be more than offset by the saving in unwarranted discounts.

There is little justification today for any kind of discount scheme. These rebates are a greater source of trouble than any benefit which may be derived from their use. Any advantage that formerly accrued to the seller by thus inducing prompt payment is in many instances now lost by the custom of post-dating invoices. The modern tendency is toward simplification. It should seriously be considered whether a system which causes so much clerical labor and creates so much friction as does that of cash discounts should not be abolished.

REVIEW QUESTIONS

1. Is cash discount on purchases when taken an income or a deduction from the cost of the goods?
2. Is cash discount on sales when taken a loss or a deduction from the selling price of the goods?
3. Describe the system of running a discount column in the cash book, and show how the entries are made both in the general ledger and in the subsidiary ledger.
4. Do you approve of the system of cash discounts?

CHAPTER XXVI

ILLUSTRATIVE CASH BOOK ENTRIES

1. Ruling of Cash Book

A columnar cash book in which a number of hypothetical transactions are entered ready for posting is presented in this chapter for the purpose of illustrating certain points in the use of controlling accounts. It should be understood that there is little uniformity in the columnar ruling of cash books and that the needs of a particular business determine the arrangement of the headings in each case. The illustration shown is not intended to present a standard form. It is given merely for the purpose of explaining the procedure of cash analysis when the details of customers' accounts are posted to the sales ledger and of creditors' accounts to a purchase ledger, with controlling accounts for each kept in the general ledger.

In the form of cash book shown in Form 11 (pages 288 and 289), it will be noted that the first amount column on each side is entitled "Net Cash." The net cash column on the debit side is used to record the cash actually received, and the corresponding column on the credit side contains the amounts of checks drawn. It is evident, therefore, that the excess of the total of this column on the debit side over the total of the corresponding column on the credit side represents the balance of cash in bank.

Adjoining the net cash column on the debit side is one for discounts allowed to customers and on the credit

side one for discounts received from creditors. Following the discount column on the debit side is a column in which are entered the gross amounts to be credited to customers' accounts in the sales ledger, the total of which at the end of each month is to be credited to the Sales Ledger controlling account. On the credit side a similar column entitled "Purchase Ledger" is used for the recording of the gross amounts to be debited to creditors' accounts, with a corresponding total debit posting to the Purchase Ledger controlling account.

On the debit side of the cash book a column is provided for the recording of cash sales and the accumulation of a monthly total for posting to the credit of a Cash Sales account. On the credit side of the cash book a column is provided for the similar collection of payments chargeable to general expense, the total of which at the end of each month is to be posted to the General Expense account in the general ledger. The last column on each side of the cash book is entitled "Sundries" and is used for the entry of items to which the other columns would not be applicable.

2. Illustrative Transactions

September, 1919

1. Cash balance $3,248.11. Purchases 8 tons coal at $6.25; $10 worth of postage stamps; and ¼ doz. brooms for store and office use at $4.20. Issued checks in payment.
8. Redeemed note payable of $500 at bank with 3 months' accrued interest, by check.
4. Received check from J. Stratton & Co. on invoice due today of $439.20 less 3%. Weekly cash sales per abstract $736.91. Petty cash expense items $6.34.

7. We received notice that one of our old customers, Maxwell Bros., became bankrupt. We have just succeeded in securing a certified check from them of $243.84, which is accepted in full of their account, at the rate of 68 cents on the dollar.
10. Paid invoices due today to the following creditors: Bliss Mfg. Co. $291.25 less 6-2%; K. Emerson Co. $428.40 less 3%, and J. Curtis $97.18 net.
11. Weekly cash sales $819.56. Petty cash expense $5.93.
15. We negotiated Browning & Co.'s note of $800 at bank. The note was dated August 11 at 3 months, with interest at 5%. The bank charged 6% discount.
18. Weekly cash sales $714.37. Petty cash expenses $5.32.
21. We sold through our broker 18 shares of N. Y. C. stock at 104½, brokerage ⅛%. We receive the proceeds by check.
24. We received $350.50 from Snyder & Co., in settlement of account to date, less 2% on an invoice of $237.95, and an old balance of $117.31 net.
25. Weekly cash sales $830.49. Petty cash expenses $7.05.
27. At a local Industrial Exhibit we were awarded a cash prize of $25.
29. Booth Mfg. Co. remit their check in full of their invoice of $196.08 less 6-2%. Our bank charges 20 cents exchange on the check.
30. We purchased a draft on New York by check at ¼% exchange, and remitted it to Jay & Co. in full of invoice of $829.67 less terms 3%. Paid salaries to date $180.

3. Cash Book Entries

Form 11 shows the entry of each transaction presented in § 2. In succeeding paragraphs comment is made on such of these entries as may not be clear.

4. Comment on Transactions

The following comments are designated with the date of the transaction given in § 2.

September 1. The balance at September 1, 1919, is entered on the receipt side of the cash book in the net cash column and repeated in the sundries column. This is not to be credited to any account, but it will correspond with the balance in the Cash account in the ledger at September 1, 1919. The amount is entered in the net cash column in order that the excess of that column over the total of the corresponding column on the credit side will represent the balance of cash in bank. The amount is repeated in the sundries column in order that the monthly totals of all columns may "cross-foot" as explained in a succeeding section.

The payments for expenses are entered on the credit side of the cash book, the details being indicated in the explanation space. The total amount of $61.05, which is assumed to have been covered by one check, is entered in the net cash column and repeated in the general expense column because the payments are chargeable to that account. In a larger business a General Expense account would not be adequate to record all the expenses, but an individual account with each kind of expense would be required. As explained in Volume II, the analysis of the expenditures for expense is generally made in a purchase journal or voucher register instead of in the cash book, but the present form is given to illustrate a procedure adequate for a small business.

3. It will be noted that the payment of this note, although made by one check, requires two lines for entry in the cash book. This results from the fact that the face

Dr. September, 1919 CASH

Date 1919	L.F.		Net Cash	Discount on Sales	Sales Ledger	Cash Sales	Sundries
Sept. 1	√	Balance	$ 3,248.11	$.....	$.....	$.....	$ 3,248.11
4	201	J. Stratton & Co.	426.02	13.18	439.20	.....	.....
4	√	Cash Sales	736.91	.....	.....	736.91	.....
7	220	Maxwell Bros.	243.84	.....	243.84	.....	.....
11	√	Cash Sales	819.56	.....	.....	819.56	.....
15	40	Notes Receivable Discounted	802.30	.....	.....	.....	810.00
	150	Discount	.....	.....	.....	.....	7.70*
18	√	Cash Sales	714.37	.....	.....	714.37	.....
21	28	N. Y. C. Stock	1,878.75	.....	.....	.....	1,878.75
24	217	Snyder & Co.	350.50	4.76	355.26	.....	.....
25	√	Cash Sales	830.49	.....	.....	830.49	.....
27	109	Prizes	25.00	.....	.....	.....	25.00
29	207	Booth Mfg. Co.	192.16	3.92	196.08	.....	.....
	√	Total per contra	$10,268.01	$ 21.86	$ 1,234.38	$ 3,101.33	$ 5,954.16
				120	30	175	√
	√	Balance September 1	3,248.11				
	1	Receipts for September	$ 7,019.90				
Oct. 1	√	Balance	$ 7,889.68				$ 7,889.68

*Written in red ink.

Form 11. (a) Cash Book, showing Ledger Controlling Entries and Discount Columns (left-hand page)

CASH — Cr.

Date 1919	Check No.	L.F.		Net Cash	Discount on Purchases	Purchase Ledger	General Expense	Sundries
Sept. 1	126	V	Coal $50, Postage.. $10, Brooms $1.05.	$ 61.05	$.....	$.....	$61.05	$.....
3	127	22	Notes Payable	500.00	.....	.....	.....	500.00
3	127	170	Interest	7.50	.....	.....	.....	7.50
4	128	V	Sundry Expenses...	6.34	.....	.....	6.34	.....
10	129	309	Bliss Mfg. Co.....	285.42	5.83	291.25	.....	.....
10	130	341	K. Emerson Co.....	415.55	12.85	428.40	.....	.....
10	131	314	J. Curtis	97.18	.....	97.18	.....	.....
11	132	V	Sundry Expenses ..	5.93	.....	.....	5.93	.....
18	133	V	Sundry Expenses ..	5.32	.....	.....	5.32	.....
25	134	V	Sundry Expenses ..	7.05	.....	.....	7.05	.....
29	—	V	Exchange	.20	.....	.....	.20	.....
30	135	322	Jay & Co.....	804.78	24.89	829.67	.....	.....
30	136	V	Exchange	2.01	.....	.....	2.01	.....
30	137	V	Salaries	180.00	.....	.....	180.00	.....
		1	Payments for September	$ 2,378.33	$ 43.57	$ 1,646.50	$ 267.90	$ 507.50
					130	20	146	V
		V	Balance September 30	7,889.68				
		V	Total per contra...	$10,268.01				

Form 11. (b) Cash Book, showing Ledger Controlling Entries and Discount Columns (right-hand page)

of the note, namely $500, is chargeable to Notes Payable account and the interest of $7.50 is chargeable to Interest account.

4. The recording of the receipt from J. Stratton & Co. is typical of receipts from customers to whom cash discounts are allowed. It will be noted that the amount of cash received is entered in the net cash column, the discount in the discount on sales column, and the gross amount to be credited to the customer's account is entered in the sales ledger column.

7. The cash book entry for the receipt from Maxwell Bros. will result in a credit to their account of the cash received, but a further credit should be made in the journal to record the fact that their account is closed. The account to be debited in this journal entry will be the Reserve for Bad Debts account in view of the fact that the customer has become bankrupt.

10. The entries for payment to creditors from whom cash discounts are received are similar to the entries for receipts from customers who have taken cash discounts, and therefore require no comment.

15. It will be noted that Browning & Co.'s note for $800 bore interest at 5 per cent. The amount receivable on the note at its maturity thus would be $810. The note, however, was discounted September 15, and the bank charged $7.70 for discount. The entry of this transaction requires a credit of $810 to Notes Receivable Discounted account and a debit to Discount account of $7.70, the amount of the cash proceeds, $802.30, being entered in the net cash column. The credit to Notes Receivable Discounted account is made for reasons explained in Chapter XXVII. The debit of $7.70

in the Discount account is in reality a journal entry but is made in the cash book for bookkeeping convenience in order that the entire transaction may be recorded in one place. As this latter entry is a debit, the amount is entered in the sundries column in red ink to distinguish it from the other entries which are to be credited to their respective accounts.

27. The credit for the cash prize of $25 is made to the Prizes account. Bookkeepers are inclined to make credits such as this to the Profit and Loss account, but such practice is not considered sound because the Profit and Loss account should be used only as a clearing house account in which to collect the balances of all the nominal accounts at the end of each fiscal period.

It is believed that the other transactions do not require comment.

5. Postings from Cash Book

The only items on the debit side of the cash book to be posted individually are those in the sales ledger column and in the sundries column. Amounts in the former column are to be credited to customers' accounts in the sales ledger, and amounts in the latter column (with the exception of the balance at September 1, 1919) are posted to the credit of the accounts specified in the general ledger, care being taken, however, to post the discount item of $7.70 entered in red to the debit of that account.

Similarly, the only items on the credit side of the cash book to be posted individually are those in the purchase ledger column and in the sundries column. The amounts in the purchase ledger column are to be debited

to accounts with creditors in the purchase ledger, and items in the sundries column are to be posted to the debit of the designated accounts in the general ledger.

In the net cash column on the debit side the balance at September 1, 1919, is deducted from the total to give the amount of receipts during the month, $7,019.90, and this amount is debited to the Cash account in the general ledger. The total of the discount on sales column is posted to the debit of that account in the general ledger. The totals of the sales ledger column and the cash sales column are posted to the credit of their respective accounts in the general ledger. The total of the sundries column is not posted because the individual items making up that total have been posted in detail. It will be noted that the total of the net cash column, $10,268.01, plus the discount on sales total, $21.86, both of which are debit items, equals the total of the three remaining columns which are credit items. Thus it will be seen that the debits from this side of the cash book equal the credits.

On the credit side of the cash book the total of the net cash column, $2,378.33, represents the total payments for the month and is credited to the Cash account in the general ledger; the total of the discount on purchases column, $43.57, is credited to that account in the general ledger. The totals of the purchase ledger column and the general expense column are debited to their respective accounts in the general ledger, and the total of the sundries column is not posted because the items composing it have been posted in detail. By adding the balance at September 30, 1919 to the total payments for September, a total of $10,268.01 is obtained

which corresponds with the total of the net cash column on the debit side and for that reason each of these amounts is designated as "total per contra," per contra implying a reference to the contra or opposite page.

CHAPTER XXVII

NOTES AND TRADE ACCEPTANCES

1. Definition of Promissory Note

A promissory note is a written unconditional promise, signed by the maker, to pay to the bearer or to the order of a named payee a certain sum in money on demand or at a fixed or determinable future time. If such a note meets all the requirements contained in the above definition, it is said to be negotiable. Under the law it may be passed freely from one person to another by indorsement—meaning that the payee or present owner signs his name on the back of the note. Unless such a signature is expressly stated to be "without recourse," the indorsee, that is, the person to whom the note is transferred, can hold his immediate indorser and all previous indorsers liable for its payment in case the maker of the note fails to pay it at maturity. Thus a contingent liability is imposed upon the indorser of a note, of which the accountant should take full note, as will be now explained.

2. Notes Receivable and Notes Payable

Notes are either receivable or payable, depending upon the point of view from which they are considered. The same note will, of course, be a note payable from the viewpoint of the maker, and a note receivable from that of the payee or present holder. Notes receivable are assets, and notes payable are liabilities, and the

titles of their respective accounts should be "Notes Receivable" and "Notes Payable." The fact that they are sometimes called "bills receivable" and "bills payable" leads to a discussion of how such a practice arose from the use of bills of exchange.

3. Bills of Exchange

A bill of exchange, commonly called a draft, is an unconditional written order to pay a certain sum in money on demand or at a fixed or determinable future time to order or to bearer and addressed to a definite person known as the drawee. Such an order obviously is of no value until it is accepted as valid by the drawee. Evidence of acceptance is the word "Accepted" written by the drawee over his signature on the face of the bill. When that is done the drawee becomes the acceptor of the bill and is the person primarily liable thereon. If he fails to pay as he has agreed to do, the drawer, who signs the bill before its presentation to the drawee, can be held, the latter thus assuming a contingent liability similar to that of an indorser.

An accepted bill constitutes a bill receivable in the hands of the holder, and a bill payable from the acceptor's viewpoint. History shows that bills were in use before notes; consequently, accounts which were first properly called "bills receivable" and "bills payable" were often continued under those same captions when, later, notes almost entirely displaced bills of exchange. Hence, to this day these titles are used. Modern practice, however, tends towards simplicity and directness and so the word "notes" is now generally substituted for "bills" in the title of such accounts.

4. Dishonored Notes

One of the requirements of a note given in the foregoing definition is that it be payable on demand or at a fixed or determinable future time. Since a note which is not paid at its maturity ceases to be payable on demand or at a fixed or determinable future time, it ceases to be a note in the eyes of the law, and therefore it should cease to be considered a note in the accounts. Dishonored notes should never be represented in a notes account on the ledger or on any statement. The bookkeeping for such notes is discussed in § 7.

5. Bookkeeping Upon Receipt of Note

The bookkeeping for notes receivable falls into three groups, covering respectively the receipt of the note, its payment, and its dishonor. When a note is received, a Notes Receivable account should be opened and debited with the face value of the note. Such a note is an asset and the account which represents it should be debited to record the acquisition of the asset. If the note is received from a debtor, his account should be credited. If it is received for money lent, the credit would be to Cash. A typical entry for the receipt of a note from a customer would be:

Notes Receivable	$.....	
To Accounts Receivable		$.....

The effect of this entry is to cancel as much of a customer's open account receivable as is covered by the note but the customer in question still remains liable for the amount of his indebtedness. The change is merely in the form of his indebtedness, a liability on the note

being substituted for that on the open account. For that reason it is sometimes desirable to indicate in his account that his indebtedness still remains, whereas under the above entry it would appear to be canceled. This can be done by inserting a brief memorandum in the explanation column of his account stating that a note has been received, this memorandum being canceled when the note is paid. If most customers settle by notes, which is rarely the case, and this information is needed, a ledger account can be provided with two amount columns on each side, in which on each side one column can be used for notes and one for open account items.

6. Bookkeeping Upon Collection of Notes

When a note receivable is collected, the entry is merely a debit to Cash and a credit to Notes Receivable. In the latter account each note may be entered on a separate line, with the credit for its payment on the same line. In this way the notes which compose the balance of the account will be apparent. However, it is better practice to use in connection with the ledger account a notes receivable register as described in § 12 and also in Volume II, in which to keep a separate record of each individual note. If interest has been collected on the note, such interest should be credited to an Interest account, as the Notes Receivable account should show only face values. In the rare case where the principal or face value of a note received from a customer includes interest on his account, the Notes Receivable account should be debited with the face of the note, the customer's account credited with the items in-

cluded in the note, and Interest account credited to show the income from interest.

All interest on notes, whether receivable or payable, should be adjusted at the end of each fiscal period to record the true expense and income for the period.

7. Bookkeeping Upon Dishonor of Note

If the maker of a note fails to pay it at maturity, Notes Receivable account should at once be credited because the note as such has ceased to exist. But the maker does not escape liability. Instead of owing money on the note he now owes it on open account, and he should be charged with the face of the note and also with any expense which may have been incurred because of his failure to pay, such as protest charges. If the note was originally credited to a customer's account, the amount of the dishonored note together with the expense should be debited to his account. If the note has been taken for a loan made, then the debit should be to a personal account with the borrower.

Notes which are dishonored should be protested. Specifically, protest means that the fact of presentation for payment and the refusal to pay are sworn to before a notary public and all indorsers notified. This formality involves some expense and this expense should be charged to the maker of the note whose failure to pay has caused it. If the note has been given to the payee's bank for collection and the bank protests it, the bank will charge the expense of protest to the payee's account. In this event the protest expense should be entered in the payee's cash book and charged to the personal account of the maker of the note. The face

of the note then should be debited to him through the journal.

8. Discounting Notes Receivable

Since a note which complies with the legal requirements specified in the definition in § 1 can readily pass from hand to hand, the payee of such a note need not wait until its maturity to realize the amount due on it if he can find anyone who is willing to buy the note from him. He will have no difficulty in selling it if his own credit is good, because when he sells it he will be required to indorse it and thus will himself become liable for its payment if the maker fails to pay. The selling of a note in this way is known as "discounting the note." Notes are usually discounted at a bank because banks make a business of purchasing notes in this manner; but the sale of a note to any person constitutes its discounting and requires the same accounting treatment.

The purchaser of a note charges interest for the accommodation he gives, and this interest charge is known as the discount on the note. The holder of the note who discounts it is willing to pay this discount in order to secure cash for the note before its maturity. Although it seems, logically, that the discount taken should be interest on the amount advanced by the purchaser of the note, the common practice is different. The purchaser of the note deducts his interest charge from the amount which he is to receive at its maturity; therefore, the holder of a note who discounts it pays interest on more money than he actually receives. Such discount is known as bank discount. While it may exceed

the legal rate, because the seller of the note does not receive all the money on which he pays interest, the practice has become so well established that it has been legalized. It is in effect interest paid in advance.

9. Bookkeeping at Time of Discount

It is obvious that cash should be debited with the amount of the proceeds received when a note is discounted, and an expense account called "Discount" should be debited with the amount of discount. It is not obvious, however, which account should be credited. It is true that the note is no longer an asset because it has been sold and title to it has been transferred to another owner. It might be argued from this that Notes Receivable account should be credited to record the decrease of the asset. This argument is good but it does not go far enough. While it is true that the asset has been decreased, an important fact must not be overlooked. That fact is the contingent liability assumed by the holder of the note when he indorsed it at the time of discount.

The liability of the person who discounts a note is contingent upon the maker's failing to pay it at maturity; and unless this liability is recorded in some way it may be forgotten. If forgotten the original holder who discounted the note may be caught without sufficient cash to meet his contingent liability should this liability become actual. The best way to record this contingent liability is to credit, at the time of discount, a new account called "Notes Receivable Discounted" instead of Notes Receivable. Such credit will not affect the Capital account because it will be offset by the Notes Re-

ceivable account which will still contain the debit for the note. The credit to the Notes Receivable Discounted account will be merely a suspended credit properly belonging to the Notes Receivable account but withheld for the time being as a warning that a contingent liability exists.

On the balance sheet the balance of the Notes Receivable Discounted account may be deducted from the balance of the Notes Receivable account; it may be stated as a contingent liability on the liability side; or both it and the equivalent amount of notes receivable may be ignored as assets and liabilities within the statement but be referred to in a footnote. Attention should always be called in some way to the contingent liability. Failure to provide for it has caused the ruin of many a business.

10. Bookkeeping Upon Payment of Discounted Note

Under the law, if an indorser of a note is not notified of its dishonor within a reasonable time, he cannot be held liable on his indorsement. Hence, one who discounts a note will be released from his contingent liability if he is not notified thereof. If, however, there is any question as to the maker's intention or ability to pay, the person who discounted the note should at its maturity ascertain by inquiry whether or not it has been paid.

The bookkeeping upon payment of the note by the maker is simple. All that is required is an entry cancelling both the contingent liability represented by Notes Receivable Discounted account and the contingent asset shown by the Notes Receivable account. The

contingent asset consists of a right to hold the maker of the note, if the indorser is obliged to pay it, and of course this right disappears when the maker pays the note. The journal entry would be:

Notes Receivable Discounted..... $.....
To Notes Receivable..... $.....

11. Bookkeeping for Dishonored Discounted Note

If a discounted note is dishonored by its maker, the person who discounted it must pay the face of the note and the expense of protest. This will be a credit to Cash. The debits should be made as follows.

Since the face of the note represents a contingent liability in the Notes Receivable Discounted account and since this liability has now become an actual one, that account should be debited with the face of the note to record the payment of the liability. The protest fee should be charged to the personal account of the maker of the note because this expense has been incurred through his failure to meet his obligation. At the same time a journal entry should be made charging to the maker's personal account the face of the note and crediting Notes Receivable. The maker's account will then show the total amount due from him. If this account should prove to be uncollectible, it can be closed out like any other worthless account receivable.

There would be no justification for charging the maker with the discount paid upon the sale of the note by the original payee because such discount is an expense incurred by the latter for the use of money. The maker is not in any way responsible for his discounting the note.

12. Note Register

Where it is the practice to issue and receive many notes, a note register should be employed in which to record them. Such a register, purchasable at any stationery store, provides pages so ruled as to show dates, names, interest rates, amounts, maturities, and all other facts needed for a complete record. These books are frequently made so that one-half may be used for notes receivable and the other half for notes payable.

In using such a register it is customary to enter all notes in the order in which they are received or issued, starting a new page for each month. Under this method the total of the notes for the month may be posted to the ledger account in one amount instead of individually. The total of the notes paid during a month may likewise be posted at the end of each month, each payment being noted currently in the register.

Another method of operating the register possesses certain advantages. Instead of entering the notes in the order received or issued, they may be entered in the order of their maturity; and in lieu of a page for all notes received or issued during a month a separate page may be used for all notes maturing each month. One page will then contain all notes maturing in January, another all those maturing in February, and so on. This arrangement shows at a glance how much will be received or paid on notes during any one month and thus is an aid in the financial management of the business. If this method is employed, the page for each month should have a summary at the bottom of all notes received or issued during that month so that postings may be made in total as under the other method.

13. Bookkeeping for Notes Payable

No comment on the bookkeeping for notes payable is needed because it resembles that for notes receivable, except, of course, the entries are reversed. Notes receivable discounted should not be merged with notes payable, because the latter are actual liabilities while the former are only contingent liabilities which rarely become actual. It is obvious that notes payable and notes receivable should not be kept in one account and yet accountants in public practice not infrequently meet with such amateurish bookkeeping.

14. Trade Acceptances

A trade acceptance is an accepted bill of exchange or draft based upon an actual transaction in trading. Drafts can be drawn and accepted for accommodation or for cash or for any other consideration; but to constitute a trade acceptance the draft should have nothing to do with any transactions except those concerning the purchase and sale of merchandise. If such trade acceptances meet the requirements of the Federal Reserve Board they may be rediscounted by banks and thus approximate the negotiability of currency.

Formerly trade acceptances were in common use in this country; but at the close of the Civil War there was so great a demand for cash and the banking facilities were so poorly adapted for the discounting of drafts that promissory notes and other forms of "one-name" paper forced the trade acceptance out of general use. It has been argued (in many cases by authorities) that this form of credit instrument might with advantage be more generally adopted. The seller of merchandise

would be benefited because at the time a sale is made all questions of price and credit would be settled and the collection of the account would be reduced to a matter of routine. The buyer by giving a trade acceptance acknowledges the correctness of the account; the seller, by being able to discount the acceptance, avoids any reduction of his working capital due to carrying the account receivable. The trade acceptance would benefit the buyer's credit. Since he expects it to be negotiated he would not be likely to overbuy as he must be prepared to meet his acceptances as they become due. His credit standing in the community would be established.

15. Bookkeeping for Trade Acceptances

No entry should be made for a draft of any sort until it has been accepted; then it should be recorded like a note receivable or payable. In fact, a trade acceptance differs from a note only in that two persons are involved in the transaction; the difference therefore is one of security and not of accounting.

CHAPTER XXVIII

ILLUSTRATIVE NOTE TRANSACTIONS JOURNALIZED

1. Use of Additional Columns

As explained in a preceding chapter, the journal was probably the only book of original entry at first employed. When it was noted that cash transactions exceeded in number all others, such transactions were taken out of the journal and given a separate book of original entry, known as the cash book. The next step in the development of the journal was to remove from it the transactions relating to purchases and sales, recording them respectively in purchase journals and sales journals.

In the ordinary business the only transactions remaining to be recorded in the journal are opening, closing, and adjusting entries. In some businesses, however, the accounts receivable and the accounts payable are sufficiently numerous to require controlling accounts, and also there are many current transactions in notes receivable and notes payable. Under these circumstances, the general journal may conveniently be columnarized in the form shown in § 3. By the use of a column each for the debits and the credits to the controlling accounts of Accounts Receivable and Accounts Payable and of Notes Receivable and Notes Payable, with an additional column each for the debits and credits to the miscellaneous accounts, the general

journal becomes virtually a combination of five journals. Entries can conveniently be made in it for posting in detail to the miscellaneous accounts in the general ledger and for the collection of monthly totals to be posted to the controlling accounts for accounts receivable and accounts payable and to the accounts for notes receivable and notes payable.

2. Illustrative Transactions

In order to present more clearly the use of such a columnar journal as that described above, a set of illustrative transactions is presented herewith. This is followed by a proper way of recording them shown in Form 12.

Sept. 1. Arthur N. Carey invests the following in a general retail store: cash $1,427.80; merchandise $1,370; furniture and fixtures $525.50; store and lot $5,000; notes and drafts due him $765.40; notes outstanding $895.80; accounts due him $1,427.50; accounts outstanding $329.50.

3. Receives of Robert Watkins on account his note for $250 at 60 days, with interest at 6%.

4. Gives Harold Avery on account Clifford Reed's 60-day sight draft for $500, dated seven days ago and accepted four days ago, less discount at 6%.

6. Receives from George Bay on account, less discount at 6%, Kay Bros. acceptance for $945.10, dated August 4, at 90 days sight and accepted six days ago.

7. Gives James Johnson on account Morton Collins' note dated 20 days ago, at 90 days, with interest at 6%, for $385.25 less discount.

9. Martin Best's account for $285.76 is due today and a draft is drawn at sight on him, less merchandise discount at 2% in favor of Charles Harlan to apply on account.

3. Illustrative Form of Journal

The following form of journal contains the record of the preceding transactions, the necessary explanations of those which are not entirely clear appearing in § 4.

Attention is invited to the headings of the columns in the journal form. In practice a six-column journal with the explanation space in the center may be purchased from a stationer and the headings inserted in ink. In many cases, however, it is possible to predetermine the exact rulings required and it then becomes more convenient to have a book made to order, with the column headings printed. It will be noted that the columns are arranged to accommodate the majority of usual transactions. For example, Notes Receivable account has a column on the debit side of the journal because practically all transactions relating to that account which would be entered in the journal would require debits to that account, the credits to that account being chiefly for collection of notes receivable, which collections would be entered in the cash book. The same comment applies to the Accounts Payable account. On the credit side of the journal a column is provided for Accounts Receivable account because most of the debits to that account would be made through a sales book. A credit column for notes payable is the only one needed in the journal because the debits to that account would ordinarily be entered in the cash book.

COLUMNAR JOURNAL

September, 1919

Notes Receivable	Accounts Payable	General	L.F.		L.F.	General	Accounts Receivable	Payable Notes
				—1—				
				Arthur N. Carey this day begins business with the following assets, liabilities and capital:				
		$1,427.80		Cash				
$ 765.40				Notes Receivable				
		1,427.50		Accounts Receivable				
		1,370.00		Merchandise Inventory				
		525.50		Furniture and Fixtures				
		5,000.00		Land and Building				
				To Notes Payable				$895.80
				" Accounts Payable		$ 329.50		
				" Arthur N. Carey, Capital		9,290.90		
				—3—				
250.00				Notes Receivable				
				To Robert Watkins			$ 250.00	
				—4—				
	$ 495.33			Harold Avery				
		4.67		Discount				
				To Notes Receivable Discounted		500.00		
				—6—				
945.10				Notes Receivable				
				To George Bay			931.87	
				" Discount		13.23		
				—7—				
	386.40			James Johnson				
		4.63		Discount				
				To Notes Receivable Discounted		385.25		
				" Interest		5.78		
				—9—				
280.04				Notes Receivable				
		5.72		Discount on Sales				
				To Martin Best			285.76	
	280.04			Charles Harlan				
				To Notes Receivable Discounted		280.04		
$2,240.54	$1,161.77	$9,765.82				$10,804.70	$1,467.63	$895.80

Form 12. Columnar Journal showing Note Transactions

4. Comment on Transactions

September 1. The entry under this date opens the new set of books by debiting accounts for assets, crediting accounts for liabilities, and crediting the excess of assets over liabilities to the proprietor's capital account. It will be noted that the amounts of notes receivable and of notes payable are entered as one item without specifying the individual notes which compose the total. The details of these amounts can be entered in the ledger account, giving one line to each note, but the usual practice is to keep the details of notes both receivable and payable in a note register, which has columns to record information concerning each note, such as its maturity date, rate of interest, indorsers, and the like. Upon opening a new set of books, it is desirable to incorporate in the opening journal entry a detailed list of notes receivable and payable to serve as a check upon the correctness of the total. Where the notes are not numerous, they may be itemized in the body of the entry. If they are numerous, it is sometimes convenient to paste into the journal an adding machine list showing the amounts of the notes with sufficient description opposite each item to identify the note. The same comment applies to the total of accounts receivable and accounts payable.

3. The fact that this note bears interest at 6% does not affect the present entry, which is a debit to Notes Receivable and a credit to the customer, of the face value of the note. As explained in a preceding chapter, it is more convenient to record in Note accounts only the face values of notes, leaving interest and discount adjustments to be made in other accounts. In the case under discussion, when the note becomes due and the interest

is collected thereon, the amount of such interest will be credited to an Interest account, the face of the note being credited to Notes Receivable. If any collection charges are incurred they should be debited to an appropriate expense account.

4. This transaction, more simply stated, means that Carey gave a 60-day sight draft for $500 to Avery in part settlement of an amount due to Avery. The draft as drawn on Reed and accepted by him was already in Carey's possession and must have been recorded among his notes receivable, there being no fundamental distinction between a note receivable and an accepted draft. Consequently, the transfer of this draft by Carey to Avery requires the crediting of a Notes Receivable Discounted account with its face value, $500. Avery's account, however, cannot be debited with $500 because the draft is not immediately collectible and it is necessary to allow Avery a credit for the interest on this amount prior to the time when he can collect it. Consequently, Avery's account is debited with $495.33 and the interest or discount of $4.67 is debited to a Discount account. The reason for crediting Notes Receivable Discounted instead of Notes Receivable is explained in Chapter XXVII. If the discounting of notes and accepted drafts, either to banks or with customers, was of frequent occurrence, it would be convenient to open a credit column in the journal for notes receivable discounted. A fundamental principle underlying the providing of special columns is that there must be a sufficient number of entries to justify the use of the column. Where the entries are not likely to exceed two or three each month, a special column is not required. It will be

noted incidently that the discount deducted from the face of the draft is interest for the unexpired time on the draft and not for its entire life. Carey cannot properly charge Avery with the interest on the draft while it was in Carey's possession.

6. This transaction indicates that Carey receives from his customer Bay a draft for $945.10, accepted by Kay Bros., payable 90 days after sight. The entry of this transaction is practically the reverse of the preceding one. Notes Receivable account is debited for the face value of the draft but the customer is credited with only $931.87; interest on the draft for its unexpired time, $13.23, being credited to an income account for discount. When the draft is paid by the acceptor, Kay Bros., Carey will receive the face value or $13.23 more than the amount credited to the customer Bay. This $13.23 is therefore an income representing the interest earned through the allowance of a credit to the customer prior to the receipt of money from him. In other words, it is a charge made by Carey for the extension of credit to Bay.

7. This transaction also involves the settlement of an account payable by the transfer or discounting of a note receivable. There is one new element, namely, the fact that the discounted note bears interest. This interest will be collected at the maturity of the note, with the result that the creditor must be debited with more than the face value. The creditor is charged with the total proceeds of the note, consisting of its face value and interest thereon less, however, the interest or discount on that amount for the unexpired time of the note. The credit for the face of the note is made to Notes Receiv-

able Discounted for reasons explained in Chapter XXVII, and an additional credit to an income account for interest is made to record the interest earned by Carey on the note.

9. The transaction under this date involves three distinct entries. The facts are that Best, who is a customer of Carey's, owes $285.76 but is entitled to a merchandise discount of 2%, or $5.72. This amount accordingly is debited to Discount on Sales and credited to Best, leaving Best indebted for $280.40. A draft is drawn on Best for this amount and turned over to a creditor, Harlan, on account of an amount due Harlan. In order to record the acceptance by Best of the draft drawn on him, an entry is made debiting Notes Receivable and crediting Best with the face value of the draft. The transfer of the draft to Harlan is recorded by debiting Harlan and crediting Notes Receivable Discounted.

5. Monthly Closing Entries

The totals of the debit columns for notes receivable and accounts payable and of the credit columns for accounts receivable and notes payable may be entered in the general columns of the journal for posting respectively to the debit and credit of these accounts. This procedure is, however, somewhat formal and in modern practice it is customary to debit and credit the four accounts involved directly from the totals of the columns in the journal. This latter procedure has been followed in the illustration shown in Form 12.

It will be noted that a total is shown for the general column on each side of the journal. No use of this total is made in posting because each item in each gen-

eral column is posted in detail, but it is convenient in using a columnar journal to have all columns added so that the total debits can readily be shown to equal the total credits made from the journal.

CHAPTER XXIX

DEPRECIATION

1. Definition of Depreciation

Depreciation is the shrinkage in value of a fixed asset due to its possession and use. Current assets also may depreciate, but no accounting record is made of it because such assets are intended for sale and any shrinkage in their value will be immediately reflected in the profit or loss on that turnover. Fixed assets, on the other hand, are not sold but are retained in the business. In the course of time it will be necessary to replace them, and such replacements do not increase the total value of all assets in the business. Therefore, the cost of such replacements is an expense of the business. As this expense is not incurred at the moment the replacement is made but occurs gradually, it is advisable to provide for it periodically so that the amount applicable to each fiscal period may be ascertained. Such shrinkage in value is known as depreciation, and in this chapter the causes of depreciation and the accounting methods of recording it will be discussed in an elementary way.

2. Causes of Depreciation

There are three principal causes of depreciation: (1) wear and tear, (2) lapse of time, and (3) obsolescence.

Wear and tear is obviously a cause of depreciation. A machine, for example, will gradually wear out. Lapse of time, while not so obviously a cause, will neverthe-

less produce depreciation. Continuing the example, if machinery is not used at all it still will depreciate merely from age; in fact, some types of machinery depreciate more rapidly when not used to a normal extent than when they are so used.

Depreciation due to obsolescence, which means the state of becoming obsolete, is the most difficult shrinkage for which to make provision. A fixed asset becomes obsolete when it is inadequate to meet the present need of the business or when some newer and better machine has been invented. Occasionally a fixed asset will become obsolete practically at once but some provision should be made currently to anticipate such a condition and it is customary to regard obsolescence as a gradual process.

3. Kinds of Depreciation

There are fundamentally two kinds of depreciation —physical and functional. Physical depreciation is a reduction in the intrinsic value of the asset itself and is due to wear and tear and lapse of time. Functional depreciation is due to the inadequacy or obsolescence of the asset although the asset may be in practically perfect condition from a physical point of view. Depreciation on a street-car will illustrate this. The car depreciates physically by wearing out; it depreciates functionally by becoming inadequate for the service required of it, due, for example, to increased traffic.

Both kinds of depreciation, physical and functional, are continually occurring. In any particular case the question, which kind of depreciation occurs faster, is an engineering matter concerning which considerable dif-

ference of opinion exists. Some engineers have gone so far as to maintain that functional depreciation is the only kind which need be considered, because before physical depreciation has rendered the asset useless the asset will have become obsolete or inadequate and accordingly will be replaced for economic reasons. In other words, their position is that in practically every case the purchase of more modern or more adequate equipment becomes advisable before the original equipment is worn out.

These questions lie chiefly in the field of engineering and therefore do not concern accountants in general business practice to any great extent. The important thing for the accountant to know is that provision must be made currently for depreciation regardless of its cause.

4. Bookkeeping for Depreciation

Since depreciation is a shrinkage in asset value, it would be logical to credit it to the account for the asset to which it applies. This is based on the rules for journalizing given in Chapter XV, which direct that an asset account should be credited to record a decrease in the asset. As a matter of practice, it is not convenient to credit the asset account directly because such procedure would make the account unduly complicated. An asset account should be debited with the cost of the asset when it is acquired, and should be credited only with the cost of such asset when it is retired from service. The credit for depreciation, instead of being made in the asset account, should be made in a so-called reserve account containing, as explained in Volume IV, suspended credits which might logically be made in the asset account itself.

A further practical advantage which results from crediting the depreciation to a so-called reserve account is that upon any loss against which insurance is carried, the original cost of the asset is clearly set forth in the asset account and the amount of depreciation is confined to a reserve for depreciation account and thus earmarked for adjustment with the insurance company.

The journal entry for depreciation of an asset, taking machinery as an example, would therefore be as follows:

Depreciation	$.....	
To Reserve for Depreciation.....		$.....

The depreciation account is purely nominal, representing a manufacturing expense, and accordingly would be closed into the Profit and Loss account. The reserve for depreciation appears as a credit balance on the ledger, but on the balance sheet it should be deducted from the book value of the asset to which it applies, leaving for the extension the net or actual value of the asset.

It is desirable to have a reserve for depreciation account for each kind of depreciable asset so that these deductions can easily be made for balance sheet purposes and proper attention given to fixing rates of depreciation. Where there is but one reserve for depreciation covering all fixed assets, there is likely to be a tendency to guess at the amount of it or to fix some arbitrary rate which has no direct connection with the actual facts of depreciation. It is evident that a stone building, for example, will not depreciate as rapidly as a frame one. If there is a separate reserve for depreciation account for each kind of building, the actual facts of deprecia-

tion are likely to be more nearly approximate in the determination of the current charge.

5. Bookkeeping for Replacements

Upon the original purchase of a fixed asset, machinery for example, the journal entry would be:

Machinery	$.....	
To Cash (or Accounts Payable).....		$.....

As depreciation is periodically provided for, the entry would be:

Depreciation	$.....	
To Reserve for Depreciation of Machinery		$.....

Assume now that the asset has completed its useful life and needs to be replaced. If it has a residual or scrap value, i.e., if it can be sold for something, a sales account should be opened and charged with the book value of the machinery. The entry for this would be:

Sale of Machinery	$.....	
To Machinery		$.....

This entry will record the retirement of the machinery by crediting its original cost.

The debit to Sale of Machinery account will not, however, give the actual book value of the machinery, because there has been an accumulation of credits for depreciation which have been temporarily suspended in the Reserve for Depreciation account. This reserve account should therefore be closed into the Sale of Machinery account so as to leave the latter debited with the

present book value of the asset to be sold. The entry to accomplish this is the following:

Reserve for Depreciation of Machinery.....	$.....	
To Sale of Machinery.....		$.....

The amount received for the machinery upon its sale as scrap or second-hand equipment should be debited to Cash, Accounts Receivable, or any other asset affected, and credited to Sale of Machinery account. This will usually leave a balance in the latter account. This balance, if a credit, represents a profit, and if a debit, represents a loss. It should be closed at once into the Capital account because it shows an increase or decrease in capital not due to the operation of the business and therefore not properly belonging in the Profit and Loss account.

Upon the purchase of new machinery which is to replace that which was retired, the entry would be:

Machinery	$.....	
To Cash (or Accounts Payable)....		$.....

A fixed asset account should be so kept as to identify the asset which has been charged to it. If a machine has a manufacturer's number or if it can be identified in some other way, this number or mark of identification should be entered in the explanation space of the machinery account in the ledger. Costs in wages, material, and supplies incurred in installing or making the machinery ready for use should also be debited to the Machinery account and identified with the particular machine installed. When such machine is retired from service the credit entry should include the installation costs and should identify the machine so that an inspection of the

account will indicate the machines on hand. They can then be inspected if verification of the account is needed.

6. Determination of Depreciation Rate

The depreciation rate is usually a percentage of cost which is to be used each year in calculating the amount chargeable for current depreciation. In fixing the rate three fundamental facts must be determined, viz., the original cost of the asset, the probable life of the asset, and its residual value. Although all three of these items were called "facts," it is evident that only the first, the original cost, is actually a fact. The probable life of the asset and its residual value are very largely matters of judgment. If the asset is machinery or anything of a technical nature, it is necessary to secure engineering judgment upon the matter and the accountant or business man is rarely competent to form a judgment. In the simpler problems of depreciation, for example that concerning office furniture and fixtures, any intelligent person can form a reasonable opinion.

In the determination of the probable life of an asset, the assumption is made that it will be maintained in proper working condition by repairs and replacements of small parts as they become worn out, for it is obvious that if an asset is not properly maintained it will depreciate much more rapidly than it otherwise would.

By deducting the residual value from the original cost of the asset the net depreciable investment is determined. This is the amount which must be written off gradually during the probable life of the asset in order to make each fiscal period bear its proper portion of the loss due to depreciation. There are three common or

standard methods of fixing the rate to be used in writing off depreciation, namely: (1) straight-line method, (2) fixed-percentage-of-diminishing-value method, and (3) sinking-fund method.

7. Straight-Line Method

Under the straight-line method the net depreciable investment is divided by the number of years of life of the asset to get equal annual charges. Assuming an asset which cost $100 with no residual value and a life of 25 years, the straight-line method calls for an annual charge of $4. This method is called the straight-line method because if a curve is plotted showing the total depreciation year after year, the points in this curve if connected will form a straight line. This is the simplest method because it does not consider interest as an element. In view of the fact that both the probable life and the residual value are so largely matters of judgment, this method is usually as satisfactory and as likely to give results which conform to the facts of depreciation as any of the more complicated methods.

8. Fixed-Percentage-of-Diminishing-Value Method

Under this method a fixed percentage of the balance of the asset account is written off each period, to reduce the balance of the account to the residual value of the asset at the termination of its useful life. This percentage is calculated each time on the balance of the original cost of the asset after such cost has been reduced by the preceding provision for depreciation. It is evident that although the percentage itself is fixed the amount of the annual charge will decrease because

the percentage is calculated each time on a diminishing amount. The percentage to be used must be determined by an algebraic formula. An explanation of the mathematics involved in that process would be beyond the scope of this series, but formulas can be found in various books of reference.*

Applying this method to an asset which cost $100 and which has a life of 25 years with a residual value of $1, requires a constant percentage of 16.8236%. The depreciation charge for the first year would be $16.82, reducing the original cost of $100 to $83.18. Applying the fixed percentage of this new amount gives a charge for the second year of $13.99. The charge for the tenth year would be $2.67 and for the twentieth year will be 42 cents. At the end of the twenty-fifth year the original cost will have been reduced to $1, and $99 will have been written off for depreciation.

The principal argument in favor of this method is that it tends to make the total expense of carrying the asset uniform throughout its life, because such expense includes not only depreciation but also repairs and maintenance. Although the charge for depreciation decreases from a heavy amount in the first years to practically nothing in the later years, the cost of repairs and maintenance increases throughout the life of the asset. Accordingly it is claimed that the annual charge for depreciation together with the expense of repairs and maintenance will make a fairly uniform total throughout the life of the asset. This method finds favor among many accountants and engineers, although it is unlikely that any asset depreciates so rapidly in its first years.

*For example, "Principles of Depreciation," by E. A. Saliers.

This method cannot logically be applied to an asset which has no residual value for the mathematical reason that under it only a percentage of the balance is written off each time, which necessarily leaves some percentage remaining. As a practical matter, however, the remaining percentage would be reduced to a negligible figure.

9. Sinking Fund Method

Under the sinking fund method a fixed amount of cash is set aside each year and accumulated at compound interest so as to produce the amount of the net depreciable investment at the termination of the life of the asset. This amount of cash can then be used to replace the asset which has depreciated. The determination of the fixed amount to be set aside periodically involves mathematics which are beyond the scope of this volume, but for practical purposes the required amounts can be ascertained from sinking fund tables.

While the amount of the annual cash deposit in the sinking fund remains fixed, the total expense or charge for depreciation is not constant because the business loses interest on the cash deposits in the sinking fund. As the fund accumulates, this loss of interest increases and accordingly there are two elements to be considered in fixing the charge for depreciation.

For an asset which costs $100 with an estimated life of 25 years and no residual value, the fixed annual deposit for the sinking fund is $2.0952. Each year $2.09½ must be deposited in the fund. The total of such cash deposits at the end of the 25 years will be $52.38. The interest accumulated on such deposits will amount at that time to $47.62. The total fund, therefore, will

amount to $100, which is the sum needed to replace the depreciated asset.

Taking into consideration the loss to the business of interest on the deposits made, the annual cost or charge for depreciation will increase. During the first year it will be $2.0952, during the tenth year $3.4129, and during the twentieth year $5.5593. The bookkeeping to record the operation of such fund would be as follows:

Sinking Fund	$.....	
To Cash		$.....
(Amount of deposit)		
Depreciation	$.....	
To Reserve for Depreciation		$.....
(Amount of deposit)		
Sinking Fund	$.....	
To Reserve for Depreciation		$.....
(Interest on Sinking Fund)		

Under the above method the real or total cost to the business will not be indicated. The annual charge for depreciation includes only the amount of the cash deposited. There is an additional cost in the loss of interest on these deposits, and this additional cost should be taken into consideration before the adoption of this method. In fact, the principal argument against it is that cash should be retained in the business instead of being deposited in a sinking fund, because generally cash is worth more to a business than it will earn as a sinking-fund investment.

10. Appreciation of Land

Business men sometimes argue that it is unnecessary to provide for depreciation if land is owned, because

land will appreciate in value sufficiently to offset all depreciation. Such argument is fallacious. If land increases in value, this increase will result in increased sales or decreased expenses. In either event the increase in the operating profit will reflect the increased value of the land to the business. If one went further than that and recorded also an increase in capital to offset the appreciation in the asset land, he would be taking this increase in land into consideration twice. An estimated increase in the market value of land should not be recorded on the books for the further reason that land is a fixed asset and not intended for sale. There can be no real profit on land unless it is actually sold, and the time for taking such profit into the accounts is after a sale has been made.

Depreciation should not be confused with fluctuation. The only element which fluctuates is the market price of an asset. The original cost cannot fluctuate. The market price of a fixed asset has no bearing upon its value to the business, because a fixed asset is not intended for sale and therefore fluctuations in market value in either direction should not be recorded in the accounts.

11. Provision for Bad Debts

A provision for uncollectible accounts receivable resembles one for depreciation because it records the belief that a loss has taken place which should be provided for during the fiscal period in which it occurred. The bookkeeping for recording such a provision is similar to that for recording depreciation, in that a Reserve for Bad Debts account is credited and Profit and Loss debited.

This so-called reserve should be deducted from the amount of accounts receivable in the preparation of a balance sheet.

Accounts receivable really do not depreciate in the same way that fixed assets depreciate. Such accounts do not gradually waste away through wear and tear or lapse of time or obsolescence. Sometimes they are worthless from their inception and sometimes they become worthless through losses or accidents sustained by debtors. The provision for bad debts is mentioned in this chapter merely because it somewhat resembles that for depreciation and because the so-called reserve account which records the credit to offset the loss is treated in the same way as the so-called reserve for depreciation. In fixing the amount of the charge to be made for uncollectible accounts receivable, the amount of sales must be taken into consideration. Past experience in each business will indicate approximately the percentage of new accounts which will prove uncollectible. This percentage of current charge sales should be debited to Profit and Loss and credited to Reserve for Bad Debts. Thereafter as individual accounts prove worthless they should be debited to the Reserve for Bad Debts.

REVIEW QUESTIONS

1. Define depreciation.
2. Why is it necessary to provide for it in the accounts?
3. Which method of calculating depreciation is the most practical for the ordinary business?
4. Should appreciation in the value of real estate be recorded in the accounts?
5. How should provision for bad debts be made?

CHAPTER XXX

THE USE OF SUBSIDIARY BOOKS ILLUSTRATED

1. Columnar Subsidiary Books

In preceding chapters the use of special columnar books, such as the cash book, sales book, purchase book, and journal, has been illustrated, but each chapter dealt with a single book. In order to recapitulate the foregoing chapters and to illustrate the recording of a set of transactions in all the books of original entry ordinarily employed in a small business, this chapter shows the entries in four books of original entry for a hypothetical set of facts and shows the preparation of a trial balance, profit and loss statement, and balance sheet from those books.

It will be recalled that each book of original entry should have a column for each controlling account in the general ledger and for each general ledger account in which only monthly totals would be of interest. For example, the cash book shown in Form 13 following contains a column each for cash sales and cash purchases. These two accounts in the general ledger show only monthly totals. If the details composing the monthly totals are desired, such details can readily be ascertained from the cash book. The cash book contains a column for accounts receivable and for accounts payable. The totals of these two columns will be posted to controlling accounts in the general ledger, which, as explained in Chapter XXIV, will agree with the total of

the balances in a customers ledger and a creditors ledger respectively. Thus columns in a book of original entry may be utilized both for controlling accounts and for summary accounts which need contain only monthly totals.

The proper use of these numerous columns is sometimes perplexing and the transactions stated in § 2 are designed to furnish the necessary practice. It is suggested that after studying the original entry for each transaction the necessary ledger account be opened for its final record and that postings be made to such accounts from each book of original entry. The correctness of the ledger posting work can then be verified by means of a trial balance, the form of which is given in § 5. The following illustrative transactions are recorded in the forms shown in § 3.

2. Transactions to be Recorded

Oct. 1. George Clark began business with $8,500 cash.
Paid rent in advance in cash $75.
Paid $527.31 for counters, shelving, and other fixtures for store use.
Bought for cash miscellaneous supplies $24.
Bought merchandise from Andrew Maxwell on account $3,878.95.

2. Paid $40 for advertisement to appear in daily paper.
3. Bought merchandise of Arthur Harrison, cash $121.08.
5. Sold Alfred Carpenter on account $400.
6. Bought of Walter Hess on account $850.
7. Cash sales per cash register $347.92.
9. Bought merchandise from Smalley Bros. on 60-day note $258.
10. Sold merchandise to Adam Morton for his 60-day note $148.50.

12. Paid Walter Hess $500 on account.
13. Received Alfred Carpenter's check for $300 on account.
14. Cash sales for week $314.30.
15. Gave Smalley Bros. a check in payment of 60-day note of 9th, less discount at 6%.
16. Paid Arthur Harrison cash $436.20 for merchandise.
18. Bought merchandise of Lewis Sadler on 30-day note $375.09.
19. Sold merchandise to John Kingsley for cash $641.84.
20. Cash sales $385.37.
23. Bought coal for store use $28.50, stamps $10, and petty cash expenses $20.

3. Illustrative Forms

CASH

Date	L.F.		Cash	Sales Cash	Receivable Accounts	General
1918						
Oct. 1		Geo. Clark, Capital.....	$ 8,500.00	$.....	$.....	$8,500.00
7		Cash Sales	347.92	347.92	.....	.....
13		Alfred Carpenter	300.00	.....	300.00	.....
14		Cash Sales	314.30	314.30	.....	.....
15		Discount on Notes Payable..	2.32	.....	.....	2.32
19		Cash Sales	641.84	641.84	.....	.....
20		Cash Sales	385.37	385.37	.....	.....
24		Notes Receivable	148.50	.....	.....	148.50
27		Cash Sales	427.51	427.51	.....	.....
29		Henry Fox	500.00	.....	500.00	.....
30		Cash Sales	278.19	278.19	.....	.....
			.....	.....	.....	.....
			.....	.....	.....	.....
			.....	.....	.....	.....
		Total per contra	$11,845.95	$2,395.13	$800.00	$8,650.82
		Balance Oct. 1.....	.....			
		Receipts	$11,845.95			

Form 13. Cash Book, showing

24. Received check from Adam Morton for his 60-day note of the 10th, less discount.
25. Sold Henry Fox bill of merchandise on account $841.30.
26. Paid Andrew Maxwell $1,000 on account.
27. Cash sales $427.51.
28. Sold Anson Dix on his 30-day note $832.40.
29. Received $500 from Henry Fox to apply on account.
30. Paid $58.10 for freight and drayage; $60 for clerk's and $70 for bookkeeper's salary; $8.10 for gas bill; $14.20 for sundry expenses. Cash sales to date $278.19.

BOOK

Date	L.F.		Cash	Cash Purchases	Accounts Payable	General
1918						
Oct. 1		Rent	$ 75.00	$.....	$.....	$ 75.00
1		Furniture and Fixtures...	527.31	.....	.....	527.31
1		Supplies	24.00	.....	.....	24.00
2		Advertising	40.00	.....	.....	40.00
3		Purchases	121.08	121.08	.....	.....
12		Walter Hess	500.00	.....	500.00	.....
15		Notes Payable	258.00	.....	.....	258.00
16		Purchases	436.20	436.20	.....	.....
23		Expense	58.50	.....	.....	58.50
24		Discount on Notes Rec....	1.14	.....	.....	1.14
26		Andrew Maxwell	1,000.00	.....	1,000.00	.....
30		Freight	58.10	.....	.....	58.10
		Salaries	130.00	.....	.....	130.00
		Expense	22.30	.....	.....	22.30
		Payments	$ 3,251.63	$557.28	$1,500.00	$1,194.35
		Balance Oct. 31.....	8,594.32			
		Total per contra.....	$11,845.95			

Ledger Controlling Entries

GENERAL JOURNAL

October, 1918

Accounts Payable	General	L.F.		L.F.	General	Accounts Receivable
			—9—			
$258.00			Smalley Bros.			
			To Notes Payable...		$ 258.00	
			—10—			
	$ 148.50		Notes Receivable			
			To Adam Morton....			$148.50
			—18—			
375.09			Lewis Sadler			
			To Notes Payable...		375.09	
			—28—			
	832.40		Notes Receivable.....			
			To Anson Dix.....			832.40
$633.09						$980.90
			—31—			
	633.09		Accounts Payable.....			
			to Accounts Receiv-			
			able		980.90	
	$1,613.99				$1,613.99	

Form 14. General Journal

SALES BOOK

	L.F.			
1918				
Oct. 5	17	Alfred Carpenter	$ 400.00	
10	18	Adam Morton	148.50	
25	19	Henry Fox	841.30	
28	21	Anson Dix	832.40	
		Accounts Receivable	$2,222.20	
		To Sales		$2,222.20

Form 15. Sales Book

PURCHASE BOOK

	L.F.			
1918				
Oct. 1	3	Andrew Maxwell	$3,878.95	
6	7	Walter Hess	850.00	
9	8	Smalley Bros.	258.00	
18	9	Lewis Sadler	375.09	
		Purchases	$5,362.04	
		To Accounts Payable..		$5,362.04

Form 16. Purchase Book

4. Comments on Entries of Transactions

October 1-7. The transactions between the dates of October 1 and October 7 are of a simple character and require no comment. If the entry of any one of them is not thoroughly understood, reference should be had to preceding chapters in which the various books of original entry are explained in detail.

9-10. A purchase or a sale which is immediately settled by a note payable or a note receivable is sometimes entered only in the Purchases and Notes Payable, or Sales and Notes Receivable accounts, as the case may be. This, however, is not the most approved practice. It is preferable to record the purchase and the sale in the individual or personal accounts with the creditor and the customer and then to offset the entries in those accounts with a credit for the note receivable and a debit for the note payable, the compensating or offsetting entry for the notes being made in the Notes Receivable and Notes Payable accounts. In this way the entire purchases or sales, or, in other words, the entire business

done with the customer and the creditor, is recorded in the individual's account. It is convenient to follow this latter procedure because it enables one to determine readily the total purchases from each creditor and the total sales to each customer during any specified period, regardless of the manner of settlement of the account. Such information is often of value when it is desired to fix terms of credit with a customer or to seek such terms from a creditor. When purchases have been many and large in volume, and when payments have been made with promptness, more liberal terms of credit on future business may often be secured than those originally granted.

12-14. The entries for the transactions on these dates require no comment.

15. By this transaction a note payable is settled before its maturity. This would necessarily require the consent of the payee unless the note read "on or before" its maturity date. As it is paid before its maturity the face value need not be paid. Interest or discount on the note for the unexpired time is deducted and a check is given for the net amount. In order to facilitate the posting of the gross amount or the face value of the note to the debit of Notes Payable, the entry in the cash book shows an apparent payment of the face value of the note offset by an apparent receipt of the amount of the discount. If Form 13 is used, either this procedure is required or the entry of the discount may be made in red ink on the credit side of the cash book. Or, a journal entry for the discount could be made and only the check entered in the cash book, but this would necessitate two postings to Notes Payable. While

the above method of recording the discount inflates the amounts of cash receipts and cash payments, it does not affect the correctness of the cash balance.

16-30. The only transaction under the dates specified which requires comment is that of the 24th, whereby a check was received from the maker of a note receivable settling the note prior to its maturity. The transaction is recorded similarly to that of the 15th except, of course, that the entries are reversed.

5. Preparation of Statements

The trial balance, the statement of profit and loss, and the balance sheet presented below provide a simple exercise in the preparation of the customary financial statements which, after all, is the ultimate object of bookkeeping. The first step in the preparation of such statements is to take a trial balance. The next step is the preparation of closing entries which are not shown in this chapter because of their simplicity and because the method of preparing them has been fully explained in Chapter VIII. Before the closing entries can be prepared it is necessary to take inventories, and in this illustrative case the inventories are assumed to be as follows:

Merchandise	$2,186.72
Books and Stationery	20.00
Furniture and Fixtures	500.00
Unused Advertising	20.00

The profit and loss account is in the running or statement form, which is generally preferred to the double-entry or account form, as being more easily understood by persons not familiar with bookkeeping forms and terminology.

TRIAL BALANCE

George Clark		$ 8,500.00
Furniture and Fixtures ($500)	$ 527.31	
Cash	8,594.32	
Accounts Receivable	441.30	
Notes Receivable	832.40	
Accounts Payable		3,228.95
Notes Payable		375.09
Purchases ($2,186.72)	5,919.32	
Freight	58.10	
Sales		4,617.33
Discount		1.18
Office Supplies ($20)	24.00	
Rent	75.00	
Salaries	130.00	
Advertising ($20)	40.00	
Expense	80.80	
	$16,722.55	$16,722.55

STATEMENT OF PROFIT AND LOSS

Sales		$4,617.33
Cost of Goods Sold:		
Purchases	$5,919.32	
Freight	58.10	
Total	$5,977.42	
Inventory, October 31, 1918	2,186.72	3,790.70
Gross Profit		$ 826.63
Expense:		
Advertising	$ 20.00	
Salaries	130.00	
Rent	75.00	
General Expense	80.80	

Office Supplies	4.00	
Depreciation on Furniture and Fixtures	27.31	
Total	$337.11	
Discount Earned	1.18	335.93
Net Profit		$ 490.70

BALANCE SHEET

Assets		*Liabilities*		
Cash	$ 8,594.32	Accounts Payable		$ 3,228.95
Accounts Receivable	441.30	Notes Payable		375.09
Notes Receivable	832.40			$ 3,604.04
Merchandise	2,186.72			
Supplies	20.00	George Clark:		
Advertising	20.00	Investment	$8,500.00	
Furniture and Fixtures	500.00	Net Profit	490.70	8,990.70
	$12,594.74			$12,594.74

CHAPTER XXXI

PARTNERSHIP ACCOUNTING—OPENING AND CURRENT ENTRIES

1. Special Features of Partnership Accounting

The accounting for a partnership differs from that for a sole proprietorship only in the opening entry, in the distribution of profits and losses, and in the liquidation entry when the partnership is dissolved. These differences are not due to any distinctive method of conducting a partnership business, but solely to the fact that in a partnership there is more than one proprietor. The present chapter discusses the opening entry and the distribution of partnership profit and loss, and in Chapter XXXII there is an explanation of the accounting procedure upon the dissolution of a partnership.

2. Necessity for Separate Capital Accounts

Where there is only one proprietor, the business is accountable to him for the entire excess of assets over liabilities. Where there is more than one proprietor, as in a partnership, the capital must in some way be apportioned and a separate capital account for each partner must be kept to indicate his share. Such an account represents the amount which would be paid to him in cash or property if the assets of the firm realized their book value when the business was dissolved and all creditors paid.

A partner's capital account is opened when he invests any assets in the firm. If the firm assumes liabilities in connection with assets which an incoming partner turns over to it, his capital account should indicate the net amount of capital invested—either by showing the assets on one side and the liabilities on the other, or by showing only the net amount. It follows from this that the capital contributed must be definitely agreed upon. If an asset other than cash forms part of the capital it must be definitely appraised, because it may not in the future realize the book value at which it is credited to the partner's capital. When once an asset is valued, any subsequent loss is a firm loss and any subsequent profit is a firm profit. If the value of such an asset be not definitely agreed upon, misunderstanding may later arise as to whether or not such loss or profit should be considered as an adjustment of the capital account of the partner contributing the asset.

3. Usual Opening Entry

In a simple and uncomplicated case, the opening entry is not difficult to prepare. In every case it is advisable to make this entry in the general journal, and to include in it a brief statement of the formation of the partnership, the names of the partners, and such other information concerning their contract as may not be too confidential for display upon the office books.

The following example of an opening entry will serve as a type for simple cases.

May 1, 1919

The firm of Brown & Peacock has this day been formed to conduct the business of general retailing

for a period of five years from date. The members of the firm are H. P. Brown and James L. Peacock, who are to share profits and losses equally and who contributed assets and for whom the firm assumed liabilities as hereunder noted.

Cash	$ 604.17	
Notes Receivable	200.00	
Curtis & Guild	17.42	
Cohn & Brother	906.00	
Hopkins & Giles	314.89	
Merchandise Inventory	1,000.00	
Furniture and Fixtures	602.00	
To H. P. Brown, Capital		$3,644.48
Assets contributed to the firm by H. P. Brown.		
H. P. Brown, Capital	315.00	
To Acme Manufacturing Co		215.00
" Whitcomb & Converse		100.00
Liabilities of H. P. Brown assumed by the firm.		
Cash	318.97	
Sharp & Burton	199.83	
Saddler & Lee	32.46	
Gilchrist & Hitchcock	481.00	
Merchandise Inventory	700.00	
Furniture and Fixtures	900.00	
To James L. Peacock, Capital		2,632.26
Assets contributed to the firm by James L. Peacock, no liabilities being assumed on his account.		

It will be noticed from the journal entry that Mr. Brown's account will show the assets on one side and the liabilities on the other. The same result could be obtained by making what is known as a compound jour-

nal entry in which only the net amount of $3,329.48 would be credited to his capital account. There is a slight advantage in showing both the assets and the liabilities, in that it would not be necessary later to refer to the journal in order to ascertain those facts.

The inclusion of cash in the above journal entries requires a word of comment. These balances of cash contributed to the firm appear also in the cash book and it is evident that they should not be entered twice in Cash account or in the capital account. Yet it is desirable that these items be included in the journal entry in order to show the complete contribution of each partner, and they must appear in the cash book because they constitute cash receipts by the firm. The way to avoid duplication of posting is to indicate in the journal that Cash account is not to be debited, and to indicate on the cash book that capital account is not to be credited. In this way Cash account will be debited from the cash book, and the capital account will be credited from the journal.

4. Opening Entry When Capital Is Indefinite

A simple example of the contributions of partnership assets upon which no specific value is placed, is the contribution of accounts receivable under an agreement that the partner's capital account is to be credited only with the amounts actually collected on such accounts. To carry out this agreement the amount of this estimated contribution should be credited to a suspense account which may be entitled ".....'s Capital Adjustment." At the end of each month the amount of the total cash collections on these accounts, as shown

by the cash book, should be journalized in the following manner:

....'s Capital Adjustment	$....	
To ....'s Capital		$....

In this way the partner's capital account will be credited only with the amounts actually collected. If any of them eventually prove to be uncollectible, they should be written off by the following entry:

....'s Capital Adjustment	$....	
To Accounts Receivable		$....

5. Opening Entry Where No Capital Is Contributed

Sometimes a partner is admitted under an agreement to give him merely an interest in the profits of the firm. This is frequently the case when an employee is made a partner and given a share of the profits in lieu of salary. When such an incoming partner contributes no assets, and when the firm assumes no liabilities for him, no capital account is needed to represent his interest. Since such an account shows the share of the capital which each partner owns, it is evident that if nothing is owned no capital account is required. In this example, the incoming partner would have a capital account only if profits were earned and he became entitled to a share of them.

An agreement of this sort should specifically state whether or not the incoming partner is to be charged with a share of possible losses. Losses are usually not contemplated but they not infrequently occur. Unless the agreement specifically provides that the new partner is to be charged with a portion of the losses, if any,

considerable ill-feeling may result when a loss has to be distributed. Whether or not a person who is to share only in the profits must also bear his portion of losses and whether or not he becomes a full partner, are questions of law which are quite beyond the scope of this volume.

6. Division of Profits and Losses

Since men may contract to do anything not prohibited by law, partners may agree to divide profits in any way desired. The most general modes of division are noted in the following section. It is not always realized, however, that in the absence of a definite agreement profits and losses must be shared equally. This rule of law is applied even though one of two partners may devote his entire time to the business and contribute all the capital, while the other partner gives neither time nor capital—the reason being that due to the intimacy of the partnership relation the law cannot determine the relative values of the partners to a given business enterprise. A partner who contributes no capital may contribute valuable services. Again, though contributing neither capital nor services, he may be the means of securing business or business advantages for the firm.

So many questions would be involved in an effort to determine how profits should be divided that the law simply states that, in the absence of agreement, profits and losses are to be shared equally. This means their division into as many parts or shares as there are partners, regardless of the balances in the partners' capital accounts.

7. Bases of Division

A common method of apportioning profits or losses is by fixed percentages. For example, one partner may be allowed three-fifths of the profit and the other two-fifths; or, in a firm of three, one may be given 50%, another 30%, and the third 20%. The division of profits and losses on such a basis presents no accounting difficulties.

Another basis of division is that of capital invested. This should be clearly defined in the partnership contract in order to avoid misinterpretation. Where the capital of each partner remains fixed, no difficulty, of course, presents itself; but if each partner's capital fluctuates, either by the addition of profits or the deduction of drawings or losses, at the end of the year a question arises as to whether this division is to be based on the capital at the beginning of the year or the capital as adjusted at the close. A question of some difficulty arises if the distribution of profits is to be based on the capital at the close of the year as adjusted by the profits, because the distribution must then be made before the basis for the division of profits is determined. Generally an agreement of this kind should be made only when the capital remains fixed, all the profits being withdrawn each year. Under such circumstances the division of profits or losses presents no difficulty.

Where the capital accounts fluctuate, a fair method is to base the distribution on capital, considering also the length of time during which it has been invested. It is evident that one partner who has had an investment of $50,000 for twelve months should not share equally with another who has had an investment of the

same amount for only nine months. As the division of profits and losses upon this basis involves some complications, the following section will describe it in detail.

8. Division on Basis of Capital and Time

The first step in distributing profits and losses under this method is to reduce the capital accounts of all the partners to a common denominator so as to furnish a basis for comparison. The best common denominator for this purpose is in each case the amount which for one month would equal the amounts actually invested during the actual time of investment. The basis upon which the equivalent amounts are thus determined is really that of their interest value. For example, $100 invested for two months would be equivalent to $200 invested for one month. The following illustrative case will make this process clear:

Partner A invested the following amounts:
  January 1, 1918 $2,000
  July 1, 1918 3,000
Partner A withdrew the following amounts:
  March 1, 1918 $1,000
  October 1, 1918 2,000
Partner B invested the following amounts:
  January 1, 1918 $3,000
  October 1, 1918 2,000
Partner B withdrew the following amounts:
  March 1, 1918 $1,000

The problem now presented is to reduce the investments of all partners to some common denominator or basis so that they can be compared. As has been stated, the most convenient method is to ascertain for each partner the amount of capital which if invested for one

month would be equivalent to the actual capital during the time that it remained in the business.

Partner A had $2,000 in the business for two months when he withdrew $1,000, leaving his capital for the next four months $1,000. On July 1, 1918 he contributed $3,000, raising his capital to $4,000, at which sum it remained for three months. On October 1, he withdrew $2,000 which reduced his capital to $2,000, at which amount it remained for three months. The problem is to ascertain what amount of capital invested for one month would be equivalent in interest value to these varying amounts left in the business for these varying periods of time. The same calculation for B's capital will furnish a basis for comparison.

The following calculations show how the equivalent amount for each partner in the hypothetical case stated above is determined:

A's Capital

Balance of	$2,000	for	2	mos.,	equivalent to	$	4,000	for	one	month
" "	1,000	"	4	"	" "		4,000	"	"	"
" "	4,000	"	3	"	" "		12,000	"	"	"
" "	2,000	"	3	"	" "		6,000	"	"	"
Actual capital during			12	"	" "		$26,000	"	"	"

B's Capital

Balance of	$3,000	for	2	mos.,	equivalent to	$	6,000	for	one	month
" "	2,000	"	7	"	" "		14,000	"	"	"
" "	4,000	"	3	"	" "		12,000	"	"	"
Actual capital during			12	"	" "		$32,000	"	"	"

In each case there has been determined the amount which for one month would be equivalent to the actual capital left in the business during the entire year. From the ready means of comparison thus afforded, it will be seen that the two investments are of the relative value of 26 and 32. A is entitled to 26/58 or 13/29, and B to 32/58 or 16/29 of the profits.

There are two ways of testing the foregoing calculations. The last balance used must agree with the balance in the capital account at the end of the year and the total number of months must equal twelve. No further calculating is needed to arrive at a basis for division of profits or losses; but, if desired, the average capital of each partner can be shown by dividing the total of the equivalents by 12. The average for A is $2,166.67, and for B $2,666.67.

9. Compensation for Unequal Capital

When partners invest capital in unequal amounts, their contract sometimes provides that interest shall be paid on the amount of capital contributed. This interest, of course, is paid by the firm itself. The tendency of such interest adjustments, as explained in the next section, is to compensate the partner with the largest investment for the excess of his contribution. Another method of compensation for either unequal capital or additional service, is to allow a partner a so-called salary which gives him compensation in excess of what he otherwise would have received. Both of these expedients are discussed in following sections. Because of their importance, the economic theories underlying them and the procedure to apply them should be studied.

10. Interest on Capital

From the economist's point of view the return from a business should be analyzed into three elements. The first is interest on capital invested, calculated at an investment rate; the second is in the nature of salary for services rendered; and the remainder of the return, if any, is regarded as profit due to venturing capital in the business.

From the accountant's point of view the entire return which a proprietor secures, whether he be in business alone or in a partnership, constitutes his profit; any division of this amount on an assumed interest basis or an arbitrary salary scheme is a matter which in the judgment of the accountant does not make the return anything except profit.

The reason for the accounting viewpoint is that interest on capital and also salaries paid to partners (as explained in the next section) do not in any way reduce the total capital invested in the business. Considered collectively, the partners are neither richer nor poorer after such adjustments have been made, although the interests of individual partners are altered. Thus interest on capital and salaries paid to partners are not actual expenses, for the reason that no one outside the business profits thereby; that is to say, the total capital of all partners is neither increased nor diminished.

Another perplexing question which sometimes arises in connection with interest, if the partnership agreement provides for interest on capital, is whether or not interest may be charged also on drawings. The law does not permit such a charge—nor is it a logical consequence of allowing it on capital. There is a fundamental differ-

ence. Each partner has access to the firm books and the law assumes that he has a knowledge of their contents and that no money can be withdrawn without knowledge, actual or implied, on the part of each partner. Therefore, if one is permitted to withdraw cash on account of his share of profits to be later determined, it would be unfair to charge him with interest thereon unless he has agreed to pay it; had he known that interest was to be charged he could have refrained from making the drawings. Consequently, without a definite understanding to that effect, interest must not be charged on drawings even though it may be credited on capital.

11. Bookkeeping for Interest on Capital

The bookkeeping of interest on capital requires merely that each partner's capital account be credited with the interest at the agreed rate and that some offsetting account be debited. It is not good practice to debit an Interest account which contains interest paid to outsiders, because the latter constitutes an actual expense of the firm, whereas interest on capital is not an expense. The best practice is to debit such interest either to the Profit and Loss account or to a special account containing no other entries.

That the effect of crediting interest on partners' capital is merely to adjust their capital accounts is shown by the following example: If A and B are partners, A's investment being $10,000 and B's $5,000, and they are to share profits and losses equally, interest at 6% on the capital of each will give A $600 and B $300. The total of the $900 so credited as interest will be distributed equally between the two, which means that

A will be charged with $450 and B with $450. The net result of this is that A's capital has been increased by $150 and B's has been decreased by the same amount.

It follows from this that if profits and losses were to be shared in the ratio of capital accounts, no effect is secured by crediting interest on capital because the so-called expense of the interest will be shared in the same amounts as the interest is credited. In the example given above, A is debited with two-thirds of $900 or $600, and B with one-third or $300—which division exactly offsets the credit in each case.

12. Salaries of Partners

So-called salaries of partners are not actual salaries, although for statistical purposes they may be so treated in the accounts. They are not actual expenses because a partner entitled to a salary is not a creditor and if there are no profits he cannot receive a salary. In case of insolvency, a partner to whom "salary" is due does not share with the creditors. The bookkeeping for such salaries should be merely a debit to a special salary account—so that the amount will not be confused with the actual salaries—and a credit to the partner's capital account.

If a partnership agreement provides a percentage of profits as salary, care should be taken so to word the contract that it will be perfectly clear whether or not the salary is itself to be considered an expense before the determination of the net profits on which the percentage is to be figured. If, for example, a partner is allowed 10% of the net profits for salary, the contract should state whether or not this 10% is to be calculated on the

net profits without counting the salary. In that case the salary would be 10% of such profits. If, on the other hand, the salary is itself to be considered an expense, then the net profits before such salary is considered constitute 110% of the actual net profits. Where the figures are large the difference in interpretation of such a clause will be material.

REVIEW QUESTIONS

1. Compare a sole proprietorship with a partnership with regard to special features of partnership accounting.
2. Compare the opening entry for a partnership with that for a sole proprietorship.
3. What should go into the opening entries of a partnership:
   (a) Usually.
   (b) When capital is indefinite.
   (c) When no capital is contributed.
4. In the case of a partnership how would you dispose of the balance of the Profit and Loss account?
5. Compare the economic with the accounting point of view with regard to interest on capital.

CHAPTER XXXII

PARTNERSHIP ACCOUNTING— DISSOLUTION ENTRIES

1. Introductory

The accounting matters in connection with the formation of a partnership were discussed in the preceding chapter. The accounting principles concerning partnership operation are no different from those found in the operation of a sole proprietorship or of a corporation. In connection with dissolution, however, the adjustment of the partners' accounts involves certain principles which have not yet been presented. This chapter discusses them.

2. Methods of Dissolution

A partnership may be dissolved voluntarily by agreement among all the partners; or involuntarily against the consent or without the consent of one or more of them. Creditors may force involuntary dissolution when a partnership is insolvent. The procedure in that event is described in Chapters XII and XIII.

3. Causes for Dissolution

The most common causes for dissolution of solvent partnerships are the following:

1. Mutual agreement of the partners.
2. Expiration of term of agreement.
3. Death of a partner.

When a partnership business is not sufficiently profitable to warrant its continuance, or when there is serious disagreement among partners, the dissolution is usually by mutual agreement. When a partnership is to exist for a definite period of time, and this period expires, the partnership will be dissolved. Even if the business be continued, a new partnership will actually be formed or will be implied by law. When a partner dies, the partnership is dissolved by law and the surviving partner or partners must settle with the estate of the deceased partner for the latter's interest.

4. Procedure Upon Dissolution

When a firm is to be dissolved the first step is to reduce sufficient assets to cash in order to pay all creditors. The law specifically provides that creditors must be paid first. The next step is to repay any loans which partners may have made to the firm; not contributions of capital but loans which it was agreed were to be repaid at some fixed time. Loans usually bear interest and such interest constitutes an actual expense of the business because it is paid in money to the partner as if he were an outside person. After liabilities to creditors and partners' loans have been paid, the remaining assets are either distributed in their existing form or they are converted into cash and the cash is distributed to partners on their capital investments. Any assets so taken by a partner must be charged against his capital investment at their book value, unless an agreement exists to turn them over to the partner at some other figure. Several perplexing questions, discussed below, present themselves in the liquidation of a partnership.

5. Bookkeeping Upon Dissolution

A going concern carries its assets at cost, with proper provision for depreciation in connection therewith. When, however, a partnership, for example, ceases to be a going concern and is to be dissolved, these assets can rarely be sold at their book values.

The best bookkeeping procedure for the ordinary realization of assets is to open a Realization of Assets account in the ledger and to debit thereto the book value of all assets to be realized. All balances in reserve for depreciation accounts should be credited to this account because they represent suspended credits properly belonging in the asset accounts for which depreciation has been provided. Cash does not need to be debited to such an account because it is, as an asset, in its final form and hence is already realized.

As cash is collected for assets sold, cash account is debited and realization of assets account is credited. Any assets distributed in kind should be debited to the capital account of the partner receiving them at their book value, in the absence of an agreement to take them at some other figure. After the last asset has been sold or distributed to partners, the Realization of Assets account then will indicate whether or not all assets have produced exactly their book values. If more has been produced, this account will have a credit balance; if less, a debit. Such profit or loss should be distributed to the partners' capital accounts like any other profit or loss. The Cash account then remains on the books in place of the former asset accounts. The final step in the liquidation is to distribute the cash remaining on hand, so that all accounts will be closed out.

6. Illustrative Problem

The basis of the following problem is an actual, litigated case. Originally, partner A invested $5,000 and partner B, $10,000. Both these amounts remained in the firm unaltered by additional contributions or by withdrawals. The partnership agreement made no mention of the method of distributing profits and losses. The firm dissolved and after creditors were paid $8,000 remained in cash.

A dispute arose in regard to the division of this $8,000 between A and B. Since the contract did not specify how profits and losses were to be divided, A maintained that the $8,000 should be divided equally. B, on the other hand, insisted that the division should be in proportion to their capital account balances; B to receive 2/3, or $5,333.33.

Neither contention is correct. A is wrong because the $8,000 is an asset and not a profit and loss item. The division of profits has no bearing whatever upon the distribution of assets. B is not correct because the capital accounts as they stand do not represent the present ownership of the partners in the remaining assets.

In the above case the first step should be the preparation of a balance sheet. A deficit of $7,000 is revealed, since the only asset is cash of $8,000 offset by capital accounts of $15,000. This deficit, representing a loss, should be divided equally between the two partners. A's capital is reduced thereby to $1,500, and B's capital to $6,500. The capital accounts as adjusted now show the ownership of each partner in the $8,000. Its distribution, therefore, would be $1,500 to A and the balance of $6,500 to B.

7. Liquidating Dividends

The payments made to a partner upon the dissolution of a firm in settlement or liquidation of his capital are known as liquidating dividends. The term dividend as here used must not be confused with that of corporation dividends—which are distributions of profit.

When a firm dissolves, it is usual to make partial payments from time to time as cash becomes available for this purpose. This method is advisable because the accumulation of cash, until the last asset has been realized, serves no useful purpose and deprives the partners of the use of money to which they are entitled.

A danger exists, however, in making partial payments or partial liquidating dividends. There is no means of knowing precisely how much each partner will finally be entitled to receive until the liquidation is completed. Hence, when partial dividends are paid, one partner may receive more than he will ultimately be entitled to, and thus he will become indebted to the other partners. It may be exceedingly difficult, if not impossible, for these others to secure reimbursement from him. When a partnership dissolves, considerable ill feeling is not uncommon and it might be necessary to resort to litigation if a partner should inadvertently be overpaid. Consequently every effort must be made to avoid such overpayment.

8. Avoiding Overpayment of Partners

Overpayments of partners can be avoided by making the first payments in such amounts as will reduce the partners' capital account balances to the profit and loss sharing ratio.

Assume that A and B are partners, sharing profits and losses 2/3 to A and 1/3 to B. At the time of dissolution A's capital account has a credit of $63,000, and B's capital account has a credit of $27,000. Assume also that the first liquidating dividend is $12,000. After the payment of this dividend the assets will be $78,000. Two-thirds of this is $52,000 and one-third is $26,000. The dividend of $12,000 should be so divided that after its payment A's capital account will represent two-thirds and B's capital account one-third of the remaining assets. Consequently $11,000 should be paid to A, thus reducing his capital to $52,000, and $1,000 to B, leaving his capital account $26,000.

Since losses on realization of assets must be charged two-thirds to A and one-third to B, neither capital account should be so reduced that it will not be sufficient to meet its share of possible losses on future realization; if it does reach this point, one partner will become indebted to the other—a situation to be avoided. If the two capital accounts are adjusted at the time of the first dividends so that they stand in the profit and loss sharing ratio, any subsequent losses and any subsequent dividends may be divided in the ratio of their capital accounts since that will be the same as the profit and loss sharing ratio.

To assume an extreme case, suppose that the remaining $78,000 of assets proved totally uncollectible. If the $12,000 dividend had been divided equally between A and B, A's capital would have been reduced to $57,000 and B to $21,000. The loss of $78,000 apportioned two-thirds to A and one-third to B would leave B indebted to A in the sum of $5,000. If the $12,000 had been appor-

tioned two-thirds to A and one-third to B, A's capital account would have been reduced to $55,000 and B's to $23,000. In that case, charging the loss of $78,000 would leave B indebted to A to the extent of $3,000. If the entire liquidating dividend had been given to B, his capital would then have been reduced to $15,000 and B ultimately would have become a debtor to A to the extent of $11,000.

If a partner objects to receiving dividends in any ratio except that of the capital accounts, although such procedure might result in an overpayment to him because of its difference from the profit and loss sharing ratio, no dividends should be paid until the final realization has taken place. As this is an inconvenient arrangement, the objecting partner will usually be inclined to accept the method outlined above.

9. Debit Balance Against Partner

A debit balance in a partner's capital account upon dissolution signifies that he is indebted to the other partners. If he refuses to pay such indebtedness and if there is no way of compelling him by litigation to do so, his debit balance becomes an uncollectible account receivable. It constitutes a loss which like any other must be written off.

If there are three or more partners, a complication arises in such a case because losses must be borne equally, or in some other ratio fixed by agreement. Here, however, the loss must be distributed otherwise because one of the original partners is in default and cannot be made to share the loss.

Assume that A, B, and C, partners, share profits

and losses 1/4, 1/4, and 1/2 respectively. Assume that A becomes indebted to B and C through inadvertent overpayments to him on his capital account and that this indebtedness against A is uncollectible. The loss on this uncollectible account must be divided then between B and C. The question arises as to the proportions in which B and C should bear this loss. Under the original agreement B bore 1/4 and C 1/2 of all losses. The loss on A's account cannot be divided in that way because it will leave 1/4 undistributed. The usual method of distributing such a loss is to consider B's portion as 1/3 and C's as 2/3, since their profit-sharing ratios of 1/4 and 1/2 respectively bear that relation to each other. One-third of the loss of the balance due from A thus becomes chargeable to B and two-thirds to C. It might be argued, however, that this loss should be borne equally by B and C because they had no agreement covering this situation and thus it would fall under the rule of law that losses are divisible equally in the absence of agreement.

10. Sale of Partnership Business

A partnership business, like any other, is frequently sold outright to a new proprietor or proprietors. It may be sold, for example, to a corporation formed by the partners themselves but which nevertheless is an independent business organization. To whomever the business is sold, it becomes necessary to make liquidating entries in the partnership books. The bookkeeping procedure in connection therewith is simple.

An account should be opened with the vendee in which to record the amount for which the business is

being sold. If sold for the exact amount of the present partners' capital, then the vendee is debited with the assets turned over to him and credited with all liabilities of the partnership assumed by him. The offsetting entries will, of course, be to the credit of the asset accounts and to the debit of the liability accounts. This will leave on the partnership books one account representing the amount due from the vendee and as many capital accounts as there are partners. When the vendee pays for the business, his account should be credited and the capital accounts debited, the actual distribution of the cash received being to the partners in the amounts called for by their respective capital accounts.

If the business be sold for a round sum which is in excess of the combined capital of all the partners, a slightly different procedure is required. A Realization and Liquidation account should be opened in the partnership books to which all assets should be debited and all liabilities credited. This account will then have a debit balance exactly offsetting the total of all the capital account balances. An account with the vendee should then be opened and debited with the agreed sale price, the credit being to the Realization and Liquidation account. The latter account will then have a credit balance which will represent what may be called the good-will of the partnership.

The creation of this good-will constitutes a profit which should be divided among the partners in their profit and loss sharing ratio. This will leave the accounts as they were under the first assumed case, with a debit balance against the vendee exactly offset by the total of the capital account balances. When the vendee

pays, the amount received should be distributed to the partners, their capital accounts being debited and the vendee's account credited. Thus all the accounts on the partnership ledger are closed.

REVIEW QUESTIONS

1. In what order must the assets of a firm be distributed upon its dissolution?
2. What are liquidating dividends?
3. How can overpayment of a partner be guarded against when making partial liquidating dividends?
4. Assume that four partners share profits and losses 1/5, 2/5, 1/4 and 3/20 and that it is impossible to collect an inadvertent overpayment to the first one upon dissolution. What disposition should be made of the overpayment?
5. Under what circumstances can a Good-Will account be created upon the dissolution of a firm and what should be done with its balance?

CHAPTER XXXIII

CORPORATION ACCOUNTING

1. Nature of Corporation

As explained in Chapter II, a corporation is a group of individuals, usually three or more, authorized by law to act in certain respects as one person, with many of the rights and privileges accorded to persons, but subject to many restrictions with which the individual need not comply. To comprehend corporation accounting, it is essential that the corporation be conceived as an entity apart from its proprietors or owners.

2. Peculiarities of Corporation Accounting

So far as current bookkeeping is concerned, the only features peculiar to the corporation are those concerning its capital investment. There are, however, certain financial procedures, such as bond issues and sinking fund provisions (to be explained in Volume IV), which are usually undertaken only by corporations although there is nothing to prevent their adoption by sole proprietorships or partnerships.

3. Legal Requirements

A fundamental legal requirement concerning a corporation, which is not obligatory in any other form of business organization, is that capital originally invested in the concern must not be withdrawn without certain legal formalities. The sole proprietor of, or a

partner in, a business may withdraw his capital as freely as he pleases, but if a business is organized in a corporate form, the person or persons in charge of the company are not permitted to withdraw any of the capital originally invested unless certain rules of law are rigidly complied with.

There is an important reason for this distinction. A sole proprietor or partner is personally liable to all creditors of the business to the full extent of his private assets. But if the business is organized as a corporation, the corporation only is liable. When a corporation has expended all its assets in the payment of creditors, no creditor then unpaid has any redress against the persons who compose the corporation. For that reason, the law endeavors to protect creditors by refusing to permit the withdrawal of capital after it has been invested in a business conducted under the corporate form.

If it were not for this legal provision, a corporation could be organized and debts incurred to the extent of its credit, after which its owners could withdraw what they personally had invested, leaving no assets other than those which the creditors themselves might have contributed—such as merchandise, or furniture and fixtures, or other fixed assets. Although the owners of a corporation are not permitted to withdraw the original capital, they are, of course, permitted to withdraw profits, this being the purpose for which every business corporation is organized.

The capital originally invested in a corporation is known as its capital stock. The profits earned constitute part of its surplus (explained below), and losses

incurred form part of its deficit. The fundamental legal requirement is that profits and losses from whatever source must be kept distinct from the capital originally invested. This does not imply an actual division of assets as between those originally contributed and those earned. Such a physical division or segregation would be impossible. The law requires merely that the accounts be so kept that the accountability for the original investment be distinctly shown on the corporation books.

4. Capital Stock

Capital stock is the designation given to the amount originally invested as capital. Since there are usually three or more investors, accounts must be provided to indicate clearly the exact amount contributed by each. This is much the same as having a separate capital account for each partner, as discussed in Chapter XXXI. But the ownership of capital stock may be widely distributed and easily transferred from one person to another, and as a rule the capital stock in a corporation is held by many individuals. Therefore some form of written evidence of ownership which can be passed from hand to hand is needed. Such written evidence is known as a "stock certificate." Thus a stock certificate may be defined as the written evidence of the amount invested by a single stockholder in the capital stock of a corporation.

The division of the capital stock into shares is largely left to the discretion of the incorporators, although the laws in many states provide a minimum and a maximum amount or value for each share, known as its "par

value." But par value is not necessarily actual value. If the total capital stock is $100,000 divided into 1,000 shares of the par value of $100 each, this does not mean that each share is worth $100. It means only that each share represents 1/1,000 of the total capital stock. The capital stock of $100,000 is worth exactly the excess of the corporation's assets over its liabilities—generally more or less than $100,000.

In order to prevent fraudulent misrepresentation in the handling of stocks, as for instance that a share of stock constitutes a demand against the corporation for the amount of its par value, laws have recently been passed permitting the issue of capital stock without any par value. Such stock is still divided into shares but each share has only a fractional or proportionate value of the total capital stock to which no money value at all has been assigned. Whether or not stock be issued under such a plan, the fact remains that a share of capital stock is not an obligation or liability of the corporation. It is merely evidence of the accountability of the corporation to the owner of the stock, for that proportion of the entire capital of the corporation which his part bears to the total capital stock.

A stock certificate may cover any number of shares. If a person makes successive investments in a corporation, he may receive a certificate upon each occasion to show the number of shares at that time acquired; or he may surrender all previous certificates and receive a new one specifying his total holdings. If he desires to sell or otherwise transfer part of the shares covered by one certificate, e.g., 200 out of 500, he must surrender the original certificate for 500, whereupon the corpora-

tion will issue two new certificates, one to the transferee for 200 shares and one to the former owner for 300.

5. Kinds of Capital Stock

If all the owners of a corporation share profits on the same basis, are subject to like restrictions, and enjoy the same privileges, only one kind of capital stock is issued —known as common stock, because all the owners are interested in common. Sometimes, however, it is necessary to offer investors certain preferences or privileges in order to induce them to subscribe for stock. For example, persons may be willing to invest in a business the future of which is problematical, provided they can secure the first profits made, or provided they can be assured that if the corporation dissolves, their investment will be paid to them before any other stockholders are reimbursed. Such investors demand preference over other stockholders and, to satisfy them, a special kind of stock known as "preferred" is issued. There may be first preferred, second preferred, and other classes of preferred stock. The preference may relate only to receiving a share of profits before other stockholders, or it may relate to claims against assets in case of dissolution, or it may cover both kinds of preference.

The profits of a corporation are divided among its stockholders in proportion to the stock held by each. Preferred stock is sometimes issued which provides that if no profits be earned in any one year, subsequent profits must first be distributed to the holders of this preferred stock before any can be distributed to other stockholders. In other words, such stock provides that the profits payable to the holders thereof (who usually

are entitled to profits to the extent of some fixed percentage of their stock) shall accumulate. Such stock is accordingly known as "cumulative" preferred stock and other preferred stock which does not carry this preference is known as "non-cumulative" stock.

Other kinds of stock may be issued but the usual classification is into common and preferred, the latter being subdivided into various classes such as first or second preferred, either of which may be cumulative or non-cumulative. A separate account in the ledger must be kept for each kind of capital stock.

6. Simple Opening Entry

Upon the formation of a corporation, an opening entry should be made in the general journal giving, first, a brief summary of the facts of incorporation in much the same way that the opening entry of a partnership summarizes the partnership contract. This journal entry should require ledger accounts for each asset for which capital stock has been issued, for each liability assumed by the corporation at its outset, and for each kind of capital stock issued in payment for the net worth acquired. It is necessary to show this information because the law provides that capital stock must be issued for cash or other property or for services of a value not less than the par value of stock issued.

A simple example of an opening entry is the following:

May 1, 1920

The Acme Manufacturing Corporation was this day incorporated under the laws of the State of New York, with authorized capital stock of $100,-

000 divided into 1,000 shares of a par value of $100 each, for the purpose of acquiring and operating the business heretofore conducted by Case, Nichols, and Jensen, to whom the entire capital stock has been issued in exchange for the following assets turned over to the corporation and the following liabilities assumed by it:

Cash	$ 1,600.00	
Accounts Receivable	12,872.00	
Notes Receivable	3,000.00	
Merchandise Inventory	64,907.00	
Furniture and Fixtures	8,112.00	
Machinery and Tools	19,509.00	
To Accounts Payable		$ 10,000.00
" Capital Stock		100,000.00

7. Bookkeeping for Capital Stock Issued

In the above example, the full amount of authorized capital stock is issued at one time in exchange for the net free assets acquired by the corporation. Consequently, the only entry needed concerning capital stock is a credit to the Capital Stock account. When, however, capital stock is issued in instalments, opinions differ as to the proper accounting procedure, and the bookkeeping requires some discussion.

The total amount of capital stock authorized to be issued must at all times be shown on the books in order to prevent the unintentional issue of more stock than has been authorized in the certificate of incorporation. To provide this safeguard, the procedure sometimes is to open an account with Authorized Capital Stock at the time the corporation is formed, debiting it and crediting Capital Stock with the par value of the entire authorized issue. When stock is actually issued, the procedure is to

debit the asset received for it and to credit Authorized Capital Stock. The result is that prior to the issue of all the capital stock, no one account shows by its balance the amount issued and outstanding. It is indicated only by the total credits in the Authorized Capital Stock account; it can be calculated by subtracting the debit balance appearing in the Authorized Capital Stock account from the credit balance in the Capital Stock account.

The foregoing procedure seems inconvenient and wholly unnecessary. The amount of authorized capital stock can easily be recorded as a memorandum at the top of the Capital Stock account in the ledger, and thus the issue of stock is safeguarded. The simplest method of recording issues of stock is to make an entry at the time of each issue, debiting the asset received and crediting Capital Stock. Subsidiary accounts should be kept in a stock ledger to record the number of shares held by each stockholder. The bookkeeping procedure and the forms required are described in Volume II, "Constructive Accounting."

Sometimes, persons subscribe for, i.e., agree to take, capital stock but do not pay for it at once. In such a case, the corporation acquires a number of accounts receivable from the subscribers and an entry should be made debiting Subscribers to Capital Stock and crediting Capital Stock. As such subscriptions are collected, either in whole or in instalments, Cash should be debited and Subscribers to Capital Stock credited. In that way the asset of accounts receivable from subscribers will always be apparent and all stock issued will be shown in one account.

8. Opening Entry Involving Good-will

A business is frequently sold for a round sum, instead of for a price based upon assets taken over and liabilities assumed. In such a case, the selling price is generally in excess of the book value of the net worth sold. This excess is compensation for good-will. Good-will is merely the probability that its present customers will continue to patronize a business. A business which has been in operation for some time acquires this good-will from the fact that its name and location and methods have become known and its customers generally are more inclined to continue trading with it than to seek new business connections. Of course, if a business has been poorly managed, it may have no good-will, but upon the sale of even a moderately well-managed business the owners may reasonably require the purchaser to pay them something for this element. It will be seen that good-will is an intangible asset which is difficult to value. There are, however, certain rules for its valuation, which are discussed in Volume IV.

Assuming that a corporation is organized to purchase a going business for which it pays a round sum to include good-will, its opening entry should indicate that fact in some definite way. The purchase of a business under such circumstances is not a violation of law because good-will, although intangible, is nevertheless an asset of value, and capital stock may legally be issued for it. Its valuation should be made by the board of directors of the purchasing corporation. Bookkeeping upon such purchase should indicate, first, that a number of assets, the individual values of all of which have not yet been definitely fixed, have been acquired

and that the total value of such assets is equivalent to the par value of capital stock issued therefor. The best way in which to show this fact is to make the following entry:

Plant and Sundry Assets.....	$110,000.00	
To Accounts Payable.....		$ 10,000.00
" Capital Stock.....		100,000.00

After the board of directors has met and placed a definite value upon each asset, including the good-will, then entries should be made on the books setting up an account for each asset so valued and crediting the Plant and Sundry Assets account. The latter account is thus used only temporarily to record the total value of all assets secured, prior to their appraisal by the board of directors.

9. Treasury Stock

In the preceding sections, attention was called to the fact that not all the authorized capital stock of a corporation need be issued at one time. The stock thus left unissued is sometimes called "treasury stock." This, however, is wrong. Treasury stock is stock which has once been issued but which has been reacquired by the corporation through donation or purchase. Treasury stock is usually secured to provide working capital and the method employed is, as a rule, as follows:

A corporation may be organized to promote a business venture of uncertain future; e.g., one based on a patent still in the experimental stage or a mining venture. The entire capital stock of such a corporation is generally issued to the owner of the patent or the mine. In order to observe legal requirements, the board of

directors meets and declares the invention or the mine worth the par of the capital stock issued for it. After the issue of such stock, the corporation is, of course, in no better financial position than the owner prior to the formation of the corporation. In fact, it is in a worse position because the expense of organization has been incurred. In order to secure cash capital with which to develop the project, outside investors must be interested. It is unlikely that such investors will be willing to pay par value for their stock because of the risk of loss; yet the law requires that capital stock be issued at not less than par. The following expedient known as the donation of stock is therefore resorted to.

The owner of the formula or the mine who has received the entire capital stock in exchange for his business, donates to the corporation a portion of such stock, usually a little less than half of it. The corporation having received this donated stock for nothing, may do with it as it likes, and proceeds to sell it at whatever price can be secured. It is not uncommon to find such stock selling at 10 cents on the dollar. The new investor in such a case acquires stock of the par value of $100 at a cost of $10. He is willing to pay $10 for $100 par value, because if the project fails, his loss will not be heavy and if it proves successful he makes much more than a normal return on his investment.

The procedure of donating stock in this way is thus seen to be a thinly veiled subterfuge by which the spirit of the law is evaded while its letter is complied with. The board of directors' valuation of the assets for which the capital stock was originally issued cannot be disputed unless there is clear evidence of fraud. Since

proving fraud is one of the most difficult procedures known in the law, it rarely happens that the board's valuation is disturbed. The net effect, so far as the public is concerned, is that stockholders actually contribute less than the par value of their stock.

Stock donated in this way and sold for what it will bring, produces cash for which the business is accountable only to the stockholders, and this cash is generally used for the working capital required in the promotion of the project. The bookkeeping for such transactions and that required for the handling of treasury stock which is purchased instead of being received by donation, will be described in Volume IV.

REVIEW QUESTIONS

1. Compare a partnership with a corporation with regard to special features of corporation accounting, assuming the business in each case is the same.
2. Compare the opening entry for a corporation with that for a partnership and with that for a sole proprietorship.
3. Define capital stock and distinguish between the different kinds.
4. Define good-will. How is it incorporated into the opening entry of a corporation?
5. Define treasury stock.
6. A corporation is formed with a capital stock of $100,000 entirely subscribed for and with three-fifths paid in cash. Make journal entries.

Part VI
Single-Entry Bookkeeping

CHAPTER XXXIV

PRINCIPLES OF SINGLE-ENTRY BOOKKEEPING

1. Fundamental Characteristic of Single-Entry Bookkeeping

The fundamental characteristic of single-entry bookkeeping and the one which distinguishes it from other systems is the fact that it keeps only personal accounts in the ledger. From the analysis of a business transaction given in Chapter IV, "Double-Entry Bookkeeping," it is evident that the recording of money, tangible assets, income, and expense is not so important as the recording of personal obligations, because troublesome misunderstandings may readily arise concerning the latter. In single-entry bookkeeping the keeping of ledger accounts, which constitute the most permanent and formal record, is confined to the most important kind of recording, namely, that concerning personal obligations. Of course, the original entries should disclose the other factors involved in each transaction.

Whenever under single-entry bookkeeping accounts of things or services are kept, they are known as memorandum accounts and are not entitled to the full faith and credit given to an account kept under the double-entry system whereby its accuracy is automatically checked. Examples of single-entry memorandum accounts are those that record wages, rent, sales, and the like.

2. The Day-Book

In single-entry bookkeeping all original entries that do not involve cash are made, day by day, as they occur, in a day-book. This record constitutes a sort of diary showing transactions in chronological order. In single-entry bookkeeping there are two books of original entry, the day-book and the cash book. Transactions not involving cash are entered first on the day-book. Cash transactions are entered first in the cash book.

The day-book may be in any form convenient for the business, but the form in common use and the method of making the entries generally adopted are illustrated in the form on page 379.

Some day-books have two columns instead of one at the right-hand edge, so that the inner one may be used for detail figures; for instance, the details of invoices received and sent. In order to avoid creating in the reader's mind any possible confusion between the day-book and the journal, the day-book is here shown with one column only and the details of the invoices are entered in the explanation space.

3. Requirements for the Day-Book

The only requirements for the day-book are that it show the name of the person whose account is affected, the amount involved, and the particulars concerning the transaction, so that they may be looked up, if necessary, at any subsequent time. Since the name of the person whose account is affected is more important than the particulars of the transaction, the name is entered first and is given a space free from any other writing.

DAY-BOOK

June, 1919

		-20-		
	210	Lasker & Edwards	Purchase of Mdse. invoiced as follows:	
			30 bbls. Grade A at $3.00 $90.00	
			10 bbls. Grade B at $2.00 20.00	$110.00
	171	James E. Curtis	Sale of Mdse. billed as follows:	
			11 bbls. Grade A at $4.00 $44.00	
			2 bbls. Grade B at $3.00 6.00	50.00

Form 17. Day-Book

The object of this is to provide ample room for the quick and legible writing of the names.

Most day-books are ruled, as in Form 17 above, with a column at the extreme left for the date, but actual usage generally puts the name of the month at the top of the page and the day of the month in the center immediately over the transactions for the day. If this plan be followed, each day's transactions will stand out more clearly as a unit by being divided into sections, than they would if the dates were placed at the left. The year should be written after the month. The col-

umn to the left designed for the day of the month is frequently used for the ledger folio after posting.

4. Inclusiveness of the Day-Book

It will be noted that both sales and purchases are entered in the day-book. Entries should also be made for every other transaction not involving the immediate receipt or payment of money. If, for example, the business whose day-book appears in Form 17, gives to Lasker & Edwards a draft drawn by it on James E. Curtis, an entry recording the draft should be made in the following manner:

—22—

Lasker & Edwards	Draft on James E. Curtis accepted by him, due 30 days. Sent to Lasker & Edwards on account.	$50.00
James E. Curtis	Draft on him in settlement of his account.	50.00

Two entries are made for what appears to be one transaction, but this does not make the system a double-entry one, because there are actually two transactions with but one entry for each.

To add the figures in the money column in the day-book would be not only unnecessary but misleading. This column contains figures covering a variety of transactions and the total would be meaningless. If the business were large enough to warrant it, more than one day-book could be used, and in that event if one were used only for sales, one only for purchases, and one for other transactions, the first two could each be added to show the total purchases and the total sales for any fixed period. The memoranda thus introduced

into the books would be of value, although the figures could not be absolutely relied upon unless the practice were carried out in sufficient detail to make the bookkeeping double-entry.

5. Necessity and Methods of Posting to Ledger

As was pointed out in previous chapters, it is necessary for practical purposes to collect all the entries concerning each person and group them in one place, the ledger, so that the sum and the net result of the transactions with him can be quickly ascertained. In the cases given, postings would be made to the account of Lasker & Edwards and to that of James E. Curtis. After posting has been completed, but not before, the page of the ledger on which appears the account to which the posting has been made, should be noted on the book of original entry opposite the entry of the transaction posted, and then in the ledger account a similar record should be made of the page of the book of original entry from which the posting is made.

6. The Ledger

Form 18 shows the postings of entries from the daybook to ledger accounts. This is the usual form of posting. It will be noticed that each account is divided by a line drawn through the center so that it has two sides in the same manner as an account under the double-entry system. In single-entry bookkeeping, informality is occasionally carried to the point where only one side of an account is used, items of an opposite nature being subtracted from the total of the other preceding items. Inexperienced bookkeepers have been known to use first

LASKER & EDWARDS

1919					1919				
June	22	Draft on Curtis due 7/22/19	D13	$50.00	June	20	Purchase	D11	$110.00

JAMES E. CURTIS

1919					1919				
June	20	Sale	D11	$50.00	June	22	Draft accepted due 7/22/19	D13	$50.00

Form 18. Ledger Accounts, showing Postings from Day-Book

the left-hand side of an account and then to carry the total to the top of the right-hand side, continuing the entries on the same page. Such practice, while designed to save the expense of paper, is likely to cause a much greater expense through the loss of time due to inaccuracies.

7. The Cash Book

In single-entry bookkeeping much importance attaches to the cash book record. In the absence of any test like a trial balance, the careful record of cash assumes much importance. The cash book in single-entry bookkeeping is in effect an account with cash but, as no account is kept in the ledger, the statement

CASH RECEIPTS

June, 1919

1919					
June	1	Balance			$2,127.89
	1	Chas. E. Brown	On acct.	157	125.00
		Joseph P. Burnet	Bill 5/16/19	165	72.82
	2	Cash Sales for the day	Mdse. Grade A, 2 bbls. at $4.00	√	8.00

CASH PAYMENTS

June, 1919

1919					
June	2	Baldwin & Co.	Invoice 5/2/19	220	$173.50
		Rent for June		√	150.00
		Office Wages		√	35.00

Form 19. Cash Book under Single-Entry Bookkeeping (left- and right-hand pages)

made in § 1 that ledger accounts are kept with persons only is not negatived by the keeping of a cash book. The cash book is thus more than a book of original entry; it is also a sort of account, since it shows all moneys received and paid out, and in this way indicates the balance of cash on hand. In practically every business cash transactions exceed in number all other transactions, so that the keeping of the day-book, in which all entries might be made, is much simplified by the use of a cash book for the original entry of cash receipts and payments.

Form 19 illustrates a convenient cash book for simple single-entry bookkeeping. In this illustration the left-hand page of the cash book is shown above the right-hand page, but in actual use the pages are opposite each other when the book is opened.

Personal debits or credits are posted from the cash book to the personal accounts in the ledger affected by the transactions.

REVIEW QUESTIONS

1. Differentiate between single and double entry.
2. What advantages has single-entry bookkeeping?
3. Enumerate three important kinds of information which may be secured from a set of double-entry records but not from a set of single-entry records.

CHAPTER XXXV

SINGLE-ENTRY STATEMENTS

1. Insufficiency of Single-Entry Ledger Accounts

In single-entry bookkeeping, ledger accounts are kept with persons only, although a record of cash is maintained in a cash book. It follows that the single-entry ledger does not usually show the assets of a business, other than the accounts receivable, although it should disclose all its liabilities, since liabilities are amounts due to persons and would therefore require accounts with those persons.

Among the assets not usually shown by the single-entry ledger are those not intended for sale, such as furniture, fixtures, and machinery; and the intangible assets, such as good-will and trade-marks, rent, insurance, and similar expenses paid in advance. Consequently, in order to determine the financial condition of a business the books of which are kept by single entry, it is necessary to determine the assets, other than the balances of cash and balances of the accounts receivable, from sources outside the ledger.

2. Statement of Condition

In order to show the financial condition of a business in which records are kept by single entry, a "statement of condition" is prepared, usually showing on one side of the page all the assets and on the other all the liabilities and the capital. If the liabilities exceed the

assets, the statement will show a deficit, which, as already defined, is the excess of liabilities over assets.

The term "balance sheet" should not be used to describe such a statement of condition, because there is nothing akin to the equilibrium of accounts as in double entry. Neither should the term "statement of affairs" be used, that term being confined to a statement of condition of a business about to be liquidated because of insolvency or for any other reason.

The "statement of condition" should be dated in such a way as to show the exact date on which the condition existed, as for example December 31, 1918. It would be inexact to head such a statement "for the year ending December 31, 1918." It applies only to the condition of the business on a specified date.

3. The Form of the Statement

There is no prescribed form of statement. The form should be such as to indicate clearly its contents and to present in a readable manner the ideas intended to be conveyed. Sometimes such a statement is prepared with the assets listed on the left side, and the liabilities and capital on the right, and so arranged that the totals are of equal amount and opposite each other. This form of statement resembles a balance sheet, but it should not be so entitled.

4. The Simplest Form of Statement

A convenient form for use by business men who are not accustomed to the technique of bookkeeping arranges the items in a single series as shown on the following page:

STATEMENT OF CONDITION

December 31, 1918

Assets:		
Cash	$ 1,500.00	
Notes Receivable	2,000.00	
Accounts Receivable	8,000.00	
Merchandise (Inventory)	7,500.00	
Furniture and Fixtures (Inventory)	300.00	
Machinery and Tools (Inventory)	2,000.00	
Land and Buildings (Inventory)	12,000.00	
Total		$33,300.00
Liabilities:		
Notes Payable	$ 1,000.00	
Accounts Payable	13,000.00	
Total		14,000.00
Capital		$19,300.00

5. Comparative Statement of Condition

Since a statement of condition shows merely the financial condition of the business on a particular date, it is evident that the progress made since some preceding date would not be disclosed by it. For example, a statement showing the condition on December 31, 1918 would not indicate any of the changes during the year. If the statement of December 31, 1918 be compared with one of January 1, 1918, the net change in each asset and liability and in the capital will be disclosed. Such statements may be combined in what is called a comparative statement of condition, in which both assets and liabilities are listed in two columns, one for each date, and the differences between them noted as

increases or decreases. The following is an example of such a comparative statement arranged in running form, liabilities being deducted from assets to determine capital.

COMPARATIVE STATEMENT OF CONDITION

December 31, 1918—January 1, 1918

Assets	Dec. 31, 1918	Jan. 1, 1918	Increase	Decrease
Cash	$ 1,500.00	$ 2,000.00		$ 500.00
Notes Receivable	2,000.00	1,000.00	$1,000.00	
Accounts Receivable	8,000.00	6,000.00	2,000.00	
Merchandise Inventory	7,500.00	9,500.00		2,000.00
Furniture and Fixtures	300.00	275.00	25.00	
Machinery and Tools	2,000.00	1,800.00	200.00	
Land and Buildings	12,000.00	12,000.00		
	$33,300.00	$32,575.00	$3,225.00	$2,500.00
Liabilities				
Notes Payable	$ 1,000.00	$ 1,500.00		$ 500.00
Accounts Payable	13,000.00	11,000.00	$2,000.00	
	$14,000.00	$12,500.00	$2,000.00	$ 500.00
Capital	$19,300.00	$20,075.00		$ 775.00

6. Inadequacy of Comparative Statement

The above statement shows the net changes including the decrease in capital, but it does not disclose the reasons for the changes. It does not indicate whether the business has made a profit or incurred a loss, although it shows that the capital has been decreased. It does not show the profit or loss because it does not indicate what the proprietor may have withdrawn during the year or what he may have contributed as new cap-

ital. This statement may be altered so as to reveal the net profit or loss by showing the drawings and contributions. Assuming that there have been no contributions but that the proprietor has withdrawn $1,500 for his personal use, the net profit would be indicated as $725. This can be shown more clearly by a summary of changes in assets and liabilities in the following form:

SUMMARY OF CHANGES OF ASSETS AND LIABILITIES

During the year ended December 31, 1918

Decrease in Merchandise Inventory	$2,000.00	
Decrease in Cash	500.00	
Increase in Accounts Payable	2,000.00	$4,500.00
Increase in Accounts Receivable	$2,000.00	
Increase in Notes Receivable	1,000.00	
Increase in Machinery and Tools	200.00	
Increase in Furniture and Fixtures	25.00	
Decrease in Notes Payable	500.00	3,725.00
Net Decrease in Capital		$ 775.00
Proprietor's Drawings		1,500.00
Net Profit		$ 725.00

7. Method of Determining Profit or Loss

The factors of changes in capital are four, two causing increases and two causing decreases. Those which increase capital are profits earned and additional assets contributed by the proprietor; those which decrease capital are losses incurred and assets withdrawn by the proprietor. It is evident, therefore, that if capital has increased and we desire to know how much of the in-

crease is due to profits earned by the business, we can determine this by eliminating the increase due to additional contributions by the proprietor. To illustrate, if the capital has increased $10,000 and the proprietor has contributed $6,000, which contribution is recorded in his proprietorship account, the increase due to profits must have been $4,000. Likewise, if the capital has decreased $1,200 and the proprietor from an examination of his bank account notices that he has withdrawn $1,000 for personal use, the decrease due to loss must have been $200.

In actual practice, however, the situations are not as simple as these. Frequently there are contributions of capital as well as withdrawals by the proprietor, and often the withdrawals exceed the decrease in capital and the contributions exceed the increase in capital. Consequently it is sometimes puzzling to determine the exact profit or loss by the method suggested in the preceding paragraph without definite rules for guidance. These rules may be expressed in the formulas given below.

8. Formulas for Determining Profit or Loss

In the following formulas the words "increase" and "decrease" relate to the capital and not to specific assets or liabilities. The word "contributions" means increases in capital due to contributions of new assets by the proprietor. The word "withdrawals" means assets withdrawn by the proprietor or his personal liabilities assumed by the business. The word "profit" and the word "loss" mean the profit or loss earned by the operations of the business.

1.	Increase	+ withdrawals	=	profit
2.	Increase	— contributions	=	profit
3.	Contributions	— increase	=	loss
4.	Decrease	+ contributions	=	loss
5.	Decrease	— withdrawals	=	loss
6.	Withdrawals	— decrease	=	profit

Where there are both withdrawals and contributions the net amount should be determined and treated as a contribution or a withdrawal, whichever is the case.

These formulas are easy to apply when the amount of capital at the beginning and at the end of the period under review has been determined and the amount of drawings and contributions ascertained. A few examples will make this clear:

1. If the capital has increased $1,500 and the proprietor has withdrawn $2,000, the profit must have been $3,500. This can be demonstrated by considering what the increase in capital would have been if the proprietor had not withdrawn anything. In that case the assets would have been $2,000 more than they were at the end of the year, and thus the increase in capital would have been $2,000 more, or $3,500 in all. An increase in capital in the absence of contributions or withdrawals would be due only to profits earned by the business; hence the profit would clearly have been $3,500. The fact that the proprietor withdrew $2,000 would not in any way affect the profits earned by the operation of the business.

2. Assuming an increase in capital of $4,000 but a contribution of $1,000, the amount of the increase due to profits must have been $3,000, because if the proprietor had not contributed the $1,000 the increase in capital would have been $3,000.

3. If, on the other hand, the contributions by the proprietor have been $6,000 and the capital has increased only $4,000, it is evident that there must have been a loss of $2,000 because otherwise the capital would have increased by the amount of the contribution.

4. If the capital has decreased $3,000 despite a contribution of $4,000, there must have been a loss of $7,000 because the business has lost not only the $4,000 contributed by the proprietor but $3,000 in addition, or a total of $7,000. In other words, the business is $3,000 worse off than at the beginning of the period, notwithstanding the fact that the proprietor contributed $4,000.

5. If the capital has decreased $1,500 but the proprietor has withdrawn $1,000, the loss must have been $500 because his withdrawals of $1,000 contributed to the decrease in capital.

6. If, on the other hand, the proprietor has withdrawn $2,500 but the capital has decreased only $1,500, the business must have made a profit of $1,000 because if the proprietor had not withdrawn $2,500 the capital would have been increased by $1,000 instead of decreased by $1,500.

9. The Asset and Liability Method

This method of determining profit or loss is known as the asset and liability method because assets and liabilities at the beginning and at the end of the period must be ascertained in order to determine changes in capital. If accounts have been kept for such items as rent, insurance, sales, or the like, they should not be used in determining the profit or loss under single entry, but the method used should be strictly that outlined above.

The reason is that such accounts as those mentioned would not be reliable unless a complete system of double-entry bookkeeping were employed.

Instead of adding the withdrawals to the increase in capital in order to determine the profit as provided in the first formula, one may deduct the drawings from the capital at the beginning of the period, the profit then being the increase in capital. For example, according to the first method, if the capital at the beginning of a period was $7,000 and at the end of the period $8,000, and the drawings during the period were $2,000, there would be a profit of $3,000. According to the second method, the same answer can also be secured by subtracting the drawings of $2,000 from the capital of $7,000 at the beginning of the period, leaving a capital of $5,000 which during the period had increased to $8,000 as the result of a profit of $3,000. The other formulas can be adjusted in the same way.

The theory of this alternative method is that the drawings were taken out of capital at the beginning of the period and not out of profits, or that contributions have been made at the beginning or end of a period rather than during the period. It is questionable whether this theory is sound because drawings are usually made on account of profits earned, since the proprietor generally does not withdraw his invested capital.

10. Tangible and Intangible Assets

In determining the profit or loss under single entry it is not, strictly speaking, proper to say that only tangible assets are considered, because tangible means concrete things which have weight and dimensions, such

as a table or a machine. Accounts receivable, for example, would not be tangible assets and yet they obviously must be considered in determining the profit or loss. What is usually in mind when the assertion is made that only tangible assets are considered, is probably that assets such as prepaid insurance, or other deferred charges, are not to be considered. This, however, is not sound. All assets of every kind should be considered in determining the capital both at the beginning and at the end of a period.

11. Inadequacy of Single-Entry Method

While the profit or loss during a given period can be ascertained from single-entry books by the method described above, the showing is incomplete. In a progressive business it is not enough to know merely that the profit or loss has been so many dollars. Every business man needs an analytical system of records to give the information necessary for proper administrative control. The executive must know how the income has been earned and what items of expense have been involved to ascertain whether or not each source of income is at the maximum, and whether each expense is being kept at the minimum. These facts cannot be ascertained unless all business transactions are recorded from day to day in books of account, which are arithmetically exact.

It is evident that under single-entry methods memorandum accounts for the various expenses, for example, might have too much or too little debited to them and there would be nothing in the accounts to call attention to the mistake. The proprietor or the bookkeeper could

detect errors in such accounts only intuitively if they seemed to be wrong in amount. Consequently, single-entry accounts cannot be relied upon for accuracy. To insure dependable statistics, the books should be kept by the double-entry method.

REVIEW QUESTIONS

1. George Crum begins business alone on January 1, 1918, with the following assets: cash $1,687.49; furniture and office fixtures worth $417.62; merchandise worth $3,546.43; and machinery worth $2,493.61. Of the cash which he invests in the business, $1,200 is borrowed from Albert King. During the year he invests no new assets and he withdraws nothing for his personal use, but he pays Albert King one-half of the amount borrowed from him.

   On December 31, 1918 the business has the following assets: cash $3,863.52; furniture and office fixtures worth $512.67; merchandise worth $3,218.45; and machinery worth $2,503.96. In addition to the amount due Albert King, the business owes Jenks & Holden $124.93 for merchandise purchased on credit.

   Has the business made a profit or incurred a loss and what is the amount of it?
2. Suppose in addition to the facts given in Question 1, Crum withdraws during the year $2,000 for his personal use. If the assets at December 31, 1918 are the same as those given in Question 1, what was the profit or loss of the business?
3. Suppose in addition to all the facts given in Questions 1 and 2 that Crum during the year invested $1,000 more of his personal cash in the business. If the assets at December 31, 1918 are the same as those given in Question 1, what was the profit or loss of the business?
4. (a) What kind of business organization did George Crum have in the case described in Question 1?

   (b) Name other forms of business organizations.

Part VII
Account Classification

CHAPTER XXXVI

ANALYSIS OF DEBIT ACCOUNTS

1. Rules for Journalizing

The rules for journalizing given in Chapter XV may be summarized as follows:

Debit an account to record:	*Credit an account to record:*
1. Increase of an asset.	1. Decrease of an asset.
2. Decrease of a liability.	2. Increase of a liability.
3. An expense.	3. An income.
4. Decrease of capital by withdrawals or otherwise than by expense.	4. Increase of capital by contributions or otherwise than by income.

In order to fix clearly in mind the application of these rules, a number of accounts are analyzed in this and the following chapter showing the usual transactions debited and credited to each of them.

2. The Trial Balance

The following trial balance contains typical accounts to be found upon the ledger of an average sized corporation before the ledger has been closed. The debit accounts found on this trial balance will be analyzed in this chapter; the credit accounts in the next chapter.

First examine the trial balance to see whether or not the account you are seeking is listed. When that account is found, study its components in the light of the

TRIAL BALANCE (Before Closing)

Debits	*Credits*
Cash	Notes Payable
Petty Cash	Accounts Payable
Accounts Receivable	Notes Receivable Discounted
Notes Receivable	Accrued Taxes
Inventory	Accrued Interest on Bonds
Purchases	Accrued Interest on Mortgages Payable
Securities Owned	Capital Stock Subscribed
Mortgages Receivable	Bonds
Subscriptions to Capital Stock	Mortgages Payable
Instalment Account	Bond Premium
Treasury Stock	Reserve for Depreciation of Buildings
Organization Expenses	Reserve for Bad Debts
Insurance Premiums Prepaid	Reserve for Sinking Fund
Interest Prepaid	Surplus
Bond Discount	Dividends
Office Supplies	Surplus from Treasury Stock
Land	Capital Stock, Common
Buildings	Capital Stock, Preferred
Furniture and Fixtures	Capital Stock with No Par Value
Sinking Fund	Sales
Good-Will	Cash Discounts Received
Returned Sales	Interest
Sales Rebates and Allowances	Premium on Capital Stock
In-Freight	Returned Purchases
Cash Discounts Allowed	Purchase Rebates and Allowances
Depreciation of Buildings	Miscellaneous Income
Bad Debts	Profit and Loss
Interest on Bonds	
Interest on Mortgages Payable	
Miscellaneous Expenses	

other accounts found on the trial balance. This precaution is given because by themselves certain accounts as shown are incomplete, whereas, viewed in the light of the entire set of accounts, they perform very important functions.

3. Detailed Analyses

CASH

Debit:	*Credit:*
1. Opening balance in bank plus cash on hand (exclusive of petty cash fund). 2. Receipts each month. Posting made at close of month from cash book footing. 3. Balance of this account should represent and agree with the balance in bank plus cash on hand (exclusive of petty cash fund), which is a current asset.	1. Disbursements. Posting made at close of month from cash book footing.

PETTY CASH

Debit:	*Credit:*
1. Amount of fund created. 2. Increases in amount of fund. 3. Balance of this account should represent the present amount of the fund, which is a current asset.	1. Decreases in amount of fund.

Accounts Receivable

Debit:	*Credit:*
1. Total amount of sales charged to customers' individual accounts from the sales book—the total footing of the accounts receivable column. This is done monthly. The amount represents all charge sales of month.	1. Total amount of credits to individual customers' accounts from the cash book; the total footing of the accounts receivable column on receipts side. The amount represents all moneys received from customers to apply on open account plus total cash discounts allowed them.
2. Adjustments increasing amounts due from customers.	2. Returns by customers which have been credited to customers' individual accounts either from (a) returned sales journal, or (b) journal, if no returned sales journal is kept.
3. Balance of this account should represent the total amount due from customers as displayed in the accounts on the customers ledger. It represents a current asset.	3. Bad debts charged off, debiting at the same time the Reserve for Bad Debts account.
	4. Adjustments decreasing amounts due from customers.

Notes Receivable

Debit:	*Credit:*
1. Face value of notes receivable received from customers or other persons, whether original transactions or renewals.	1. Cash received on notes receivable, the face value of notes sold and notes renewed.

NOTES RECEIVABLE (Continued)

2. Balance should represent face value of notes receivable on hand and notes receivable discounted at the bank, the latter being offset by a credit in the Notes Receivable Discounted account. Notes receivable are current assets.	

INVENTORY

Debit:	*Credit:*
1. Amount of goods on hand at beginning of period. 2. Amount of inventory at end of period as taken up in Purchases account. This posting is made after this account has been closed by credit entry (1).	1. Amount of beginning inventory should be transferred to Purchases account when books are closed.

PURCHASES

Debit:	*Credit:*
1. Cost of all merchandise purchased for trading purposes. 2. Freight and cartage in. 3. Beginning inventory from inventory account. This amount is the inventory balance as it exists before closing.	1. Returned purchases. 2. Purchase rebates and allowances. 3. Inventory—amount of goods on hand at end of period, debiting Inventory account. 4. Amount of balance should be transferred to Profit and Loss so that Purchases account will be closed.

Securities Owned

Debit:	*Credit:*
1. Cost of stocks and bonds (of other corporations) purchased. When a corporation acquires its own stock, Treasury Stock account is debited instead of the present one.	1. Selling price of stocks and bonds (of other corporations) sold.
2. Amount of balance, if credit, transferred to Profit and Loss, thus closing this account.	2. Inventory—amount of stocks and bonds on hand at end of period, at cost price.
3. Inventory at end of period, per credit entry 2. This posting is made after this account has been closed by debit entry 2 or credit entry 3, as the case may require.	3. Amount of balance, if debit, transferred to Profit and Loss, thus closing this account.

Mortgages Receivable

Debit:	*Credit:*
1. Face value of mortgages receivable received, whether original transactions or renewals of former mortgages.	1. Payments received, face value of mortgages sold or renewed.
2. Balance should represent face value of mortgages receivable on hand. They are current assets.	

Subscriptions to Capital Stock

Debit:	*Credit:*
1. Amount of subscriptions for capital stock sold on the instalment plan, crediting at same time the Capital Stock Subscribed account. 2. Balance of this account should represent the amount receivable but not yet due on subscriptions for capital stock sold on the instalment plan. It is offset by the balance of the Capital Stock Subscribed account. It represents a current asset because its balance will be converted into cash.	1. Money received to cover subscriptions in full. 2. Amount of instalments as they become receivable, the debits being made to Instalment account.

Instalment Account

Debit:	*Credit:*
1. Amount of instalments due by subscribers to shares of stock, crediting Subscriptions to Capital Stock account. 2. Balance represents instalments receivable.	1. Cash received on account of instalment subscriptions.

Note: Account is opened each time an instalment falls due, and it remains open until cash is received in full for the particular instalment.

Treasury Stock

Debit:	*Credit:*
1. Par value of treasury stock acquired. Cash or other asset account is credited to record any consideration paid for treasury stock; any difference between the par value and the consideration paid is credited or debited to Surplus from Treasury Stock account, as the case may require.	1. Par value of treasury stock sold or otherwise disposed of. Cash or other asset account is debited to record any consideration received; any difference between the par value and the consideration received is debited or credited to Surplus from Treasury Stock account, as the case may require.
2. Balance represents the par value of treasury stock on hand. The stock is not an asset. The balance of the account represents a reduction of capital stock issued.	

Organization Expenses

Debit:	*Credit:*
1. Cost of all organization expenses—incorporation expenses, attorney's fees, promoters' services, etc.	2. Proportionate periodical amount of the debits based upon the number of years over which these expenses are to be spread, debiting Profit and Loss at the same time.
2. Balance of this account should represent the portion of organization expenses which are to be charged off to Profit and Loss. It represents a deferred charge.	

Insurance Premiums Prepaid

Debit:	*Credit:*
1. Amount of insurance premiums prepaid. 2. Balance of this account should represent the cost of insurance premiums unexpired. It represents a deferred charge.	1. Amount of refunds by insurance companies. 2. Periodical proportion of prepaid premiums which are applicable to the period just ended, debiting Insurance.

Interest Prepaid

Debit:	*Credit:*
1. Amount of interest paid in advance on money borrowed. 2. Balance of this account should represent the amount of interest paid in advance which is a deferred charge.	1. Periodical proportion of interest paid in advance, debiting Interest account.

Bond Discount

Debit:	*Credit:*
1. Amount of discount allowed on sale of company's bonds. 2. Amount of other bond issue expenses incurred at the date of issue. 3. Balance represents a deferred charge, to be charged off during the life of the bonds.	1. Proportionate amounts written off periodically to Profit and Loss account.

Office Supplies

Debit:	*Credit:*
1. Cost of office supplies purchased in such large quantities that some of them are sure to be on hand when the first profit and loss statement, following their purchase, is made up. 2. Balance of this account represents cost of office supplies on hand. Strictly speaking, this is an asset but it is more conservative to regard it as a deferred charge.	1. Periodical proportion of cost of office supplies used, debiting the proper expense accounts therefor.

Land

Debit:	*Credit:*
1. Cost of land acquired. 2. Expenses incident to acquiring title—legal fees, recording fees, etc. 3. Cost of improvements—grading, road building, curbing, etc. 4. Cost of surveys, maps, etc. 5. Carrying charges until buildings are erected, or until land becomes productive—taxes, interest on mortgage, etc. 6. Balance of this account should represent the cost of land owned which is a fixed asset.	1. Selling price of land sold. 2. The profit or loss on sales should be transferred to Surplus account.

Buildings

Debit:	*Credit:*
1. Cost of buildings acquired. 2. Construction cost when constructed. 3. Cost of all additions. 4. Cost of alterations which increase usefulness or actual value of buildings. 5. Excess of replacement cost over original cost of part replaced. 6. Balance of this account should represent the cost of buildings owned, which are fixed assets.	1. Cost of buildings destroyed. 2. Selling price of buildings sold. 3. The profit or loss on sales should be transferred to Surplus account.

Note 1. If the purchase price of real estate includes both land and buildings, it should be analyzed and the estimated cost of each charged to its account.

2. This account may be subdivided as may be desirable.

Furniture and Fixtures

Debit:	*Credit:*
1. Cost of furniture and fixtures acquired, including cost of transportation and installation. 2. Cost of all additions and betterments. 3. Balance of this account should represent the cost of furniture and fixtures owned, which is a fixed asset.	1. Cost of furniture and fixtures replaced or discarded, debiting (a) cash or its equivalent for the amount received if furniture and fixtures have been sold; and (b) Reserve for Depreciation of Furniture and Fixtures for the difference between the cost and the amount received.

Sinking Fund

Debit:	*Credit:*
1. Cash transferred from general funds of the business to a special fund for the specific purpose of meeting some fixed obligation at a particular time. 2. Income derived from the sinking fund, crediting at the same time the Reserve for Sinking Fund account. 3. Balance of this account should represent the accumulated amount of the sinking fund which is an asset.	1. Amounts of money disbursed for the purpose for which the special fund was set aside.

Good-Will

Debit:	*Credit:*
1. Actual cost of good-will acquired upon the purchase of a going business. 2. Balance of this account should remain unchanged, unless it is desired to write off the amount of good-will gradually over a period of years. It is a fixed asset of an intangible nature.	1. Amounts written off, charging Surplus account.

Returned Sales

Debit:	*Credit:*
1. Goods returned by customers, crediting customers' accounts therefor at same time. Selling price is used. 2. Balance of this account to be periodically transferred to Sales account, after which this account is closed.	

Sales Rebates and Allowances

Debit:	*Credit:*
1. Total amount as shown in rebate journal. 2. Balance to be periodically transferred to Sales account, after which this account is closed.	

In-Freight

Debit:	*Credit:*
1. Freight inward on all merchandise purchased for trading purposes. In-freight may be charged direct to Purchases account. 2. Amount of balance to be periodically transferred to Purchases account, after which this account is closed.	

Cash Discounts Allowed

Debit:	*Credit:*
1. Total amount of discount allowed customers and credited to them from the discount column on the receipt side of the cash book. 2. Amount of balance should be transferred to profit and loss when books are closed.	

Depreciation of Buildings

Debit:	*Credit:*
1. Proportionate periodical amount of estimated depreciation, crediting at the same time Reserve for Depreciation of Buildings account. 2. Balance of this account to be periodically transferred to profit and loss account.	

Note:—Depreciation on other assets is handled in the same way.

Bad Debts

Debit:	*Credit:*
1. Proportionate periodical estimated loss on bad accounts. 2. Balance of this account to be periodically transferred to Profit and Loss, after which this account is closed.	

Interest on Bonds

Debit:	*Credit:*
1. Interest on bonds outstanding applicable to the closed period under consideration, crediting the Accrued Interest on Bonds account. 2. Balance of this account represents a fixed charge against income, and is to be periodically transferred to profit and loss, after which this account is closed.	

Interest on Mortgages Payable

Debit:	*Credit:*
1. Interest on mortgages payable outstanding applicable to the closed period under consideration, crediting Accrued Interest on Mortgages Payable account. 2. Balance of this account represents a fixed charge against income, and is to be periodically transferred to the Profit and Loss account, the present account being thereby closed.	

MISCELLANEOUS EXPENSES (One account for each)

Debit:	*Credit:*
1. All items of expense not taken up thus far. 2. Balance of each account to be periodically transferred to Profit and Loss, after which each of these expense accounts will be closed.	1. All deductions from expenses as shown contra.

CHAPTER XXXVII

ANALYSIS OF CREDIT ACCOUNTS

1. Introductory

The credit accounts listed on the trial balance given in Chapter XXXVI are analyzed in this chapter. Should it be desired to locate a certain account readily, the trial balance should first be examined to find out whether or not the desired account is discussed. Attention is again called to the fact that each account should be viewed in the light of all the transactions presented.

2. Detailed Analyses

NOTES PAYABLE

Debit:	*Credit:*
1. Cash paid on notes when redeemed by the business and face value of notes renewed or otherwise canceled.	1. Face value of all notes when issued by the business. 2. Balance of this account should represent the aggregate face value of notes of the business outstanding. They are current liabilities.

ACCOUNTS PAYABLE

Debit:	*Credit:*
1. Total amount of debits to trade creditors' individual accounts from cash book. The amount represents all	1. Total amount of indebtedness incurred by the business with trade creditors on open account.

ACCOUNTS PAYABLE (Continued)

moneys paid to trade creditors to apply on open account plus total cash discounts allowed by them. 2. Returns which have been debited to creditors' individual accounts either from (a) returned purchases journal; or (b) journal, if no returned purchases journal is kept. 3. Adjustments decreasing the accounts payable.	2. Adjustments increasing the accounts payable. 3. Balance of this account should represent the total amount owing trade creditors as displayed in the accounts on the creditors' ledger, or the aggregate amount of unpaid vouchers if the voucher system is in use. It represents a current liability.

NOTES RECEIVABLE DISCOUNTED

Debit:	*Credit:*
1. Face value of notes previously discounted which have become due and have been paid, crediting at the same time the Notes Receivable account. 2. Cash payments of face value of notes defaulted by makers.	1. Face value of notes discounted, debiting at the same time the Cash account for the amount of cash received, and the Discount Lost account for the discount taken by the bank. 2. Balance of this account should represent notes discounted for which the company is contingently liable. It represents a contingent liability.

ACCRUED TAXES

Debit:	*Credit:*
1. Amount of tax bills when they are paid.	1. Periodical proportionate amount of taxes accrued,

Accrued Taxes (Continued)

	debiting the Taxes account, or some other expense account. 2. Balance of this account should represent taxes accrued but not due. It represents a liability.

Accrued Interest on Bonds

Debit:	*Credit:*
1. Amount of payments of interest on bonds outstanding.	1. Periodical proportionate amount of interest accrued on outstanding bonds during the closed period under consideration, debiting Interest on Bonds account. 2. Balance of this account should represent interest accrued and not due. It represents a liability.

Accrued Interest on Mortgages Payable

Debit:	*Credit:*
1. Amount of payments of interest on mortgages outstanding.	1. Periodical proportionate amount of interest accrued on outstanding mortgages payable during the closed period under consideration, debiting Interest on Mortgages Payable. 2 Balance of this account should represent interest accrued and not due. It represents a liability.

Capital Stock Subscribed

Debit:	*Credit:*
1. Amount of subscriptions (par value) that have been fully paid for by subscribers, crediting Capital Stock account at the same time.	1. Amount of subscriptions for capital stock sold on the instalment plan, debiting the Subscriptions to Stock account at the same time. 2. Balance of this account should offset the amount of subscriptions uncollected.

Bonds

Debit:	*Credit:*
1. Par value of bonds retired.	1. Par value of bonds issued or assumed. 2. Balance of this account should represent par value of bonds outstanding. It represents a fixed liability if the bonds do not mature in one year.

Mortgages Payable

Debit:	*Credit:*
1. Payments made on account of the principal of mortgages issued or assumed.	1. Principal of mortgages issued or assumed. 2. Balance of this account should represent the amount due on the principal of mortgages issued or assumed. It represents a fixed liability.

Bond Premium

Debit:	*Credit:*
1. Proportionate amounts written off periodically to profit and loss.	1. Amount of premium received on bonds sold above par. 2. Balance of this account should represent the amount of bond premium not yet written off. It represents a deferred credit item.

Reserve for Depreciation of Buildings

Debit:	*Credit:*
1. Cost of replacements.	1. Proportionate periodical amount of estimated depreciation, debiting at the same time (a) Depreciation of Buildings account if building is used for business purposes; or (b) Rental Income if building is rented to outsiders. 2. Balance of this account should represent the amount reserved available for such replacements and renewals as cannot fairly be considered as maintenance.

Note: All reserves for depreciation of assets are handled in the manner indicated above. Other examples will not be given.

Reserve for Bad Debts

Debit:	*Credit:*
1. Balances of accounts considered to be uncollectible, crediting at the same time the customers' accounts for the amounts charged off.	1. Proportionate periodical amount of estimated loss on bad accounts during the year. This amount is a percentage of the sales for the period, estimated to be sufficient to provide for losses on the accounts charged during the period, debiting at the same time Bad Debts account. 2. Balance of this account should represent the amount reserved available for writing off bad debts.

Reserve for Sinking Fund

Debit:	*Credit:*
1. Deductions due to loss or return of cash deposited in the sinking fund. 2. Amount of transfers or appropriations from the sinking fund.	1. Amount appropriated out of profits at periodic intervals to offset the sinking fund, debiting either Surplus or Profit and Loss. 2. Amount of all income from the sinking fund, as interest or dividends. 3. Amount of profits on sales of securities belonging to the sinking fund. 4. Balance represents the surplus invested in the sinking fund.

Surplus

Debit:	*Credit:*
1. Amount of dividends declared.	1. Net profit as shown periodically by the Profit and Loss account.
2. Amounts periodically reserved for Sinking Fund Reserve account.	2. Adjustments increasing surplus; e. g., profits of former fiscal periods not previously credited; assets acquired through donation, etc.
3. Adjustments reducing surplus.	3. Balance of this account should, at the close of any fiscal period, represent the undivided profits. They are part of the capital.
4. Loss shown by the Profit and Loss account.	

Dividends

Debit:	*Credit:*
1. Amount of dividends paid, whether by cash or by an issue of stock or otherwise.	1. Amount of dividends declared, debiting Surplus account at the same time.

Surplus from Treasury Stock

Debit:	*Credit:*
1. Excess of cash or other consideration paid for treasury stock over its par value.	1. Excess of par value of treasury stock acquired over amount of cash or other consideration paid for it.
2. Excess of par value of treasury stock sold or otherwise disposed of, over cash or other consideration received for it.	2. Excess of cash or other consideration received over par value of treasury stock sold.

NOTE: When treasury stock has been completely disposed of, the balance of this account should be closed into Surplus.

CAPITAL STOCK, COMMON

Debit:	*Credit:*
1. Par value of any common shares retired.	1. Par value of any common shares issued.

CAPITAL STOCK, PREFERRED

Debit:	*Credit:*
1. Par value of any preferred shares retired.	1. Par value of any preferred shares issued.

CAPITAL STOCK WITH NO PAR VALUE

Debit:	*Credit:*
1. Number of shares retired, at price at which they were credited to this account when issued.	1. Number of shares issued, at sale price thereof, debiting cash, or other property account, or subscriptions, as case may be. 2. Subsequent sales, at sale price thereof.

SALES

Debit:	*Credit:*
1. Balance of Returned Sales account. 2. Balance of Sales Rebates and Allowances account.	1. Amount of total charge sales during period. 2. Amount of total cash sales during period. 3. Balance to be periodically transferred to Profit and Loss account, after which this account will be closed.

Cash Discounts Received

Debit:	*Credit:*
	1. Total amount of discount allowed us by creditors and debited to them from the discount column on the payment side of the cash book. 2. Amount of balance should be transferred to profit and loss when books are closed, after which this account will be closed.

Interest

Debit:	*Credit:*
1. Amount of discount on notes discounted. 2. Amount of the interest paid on notes or loans at the date of their maturity, or from time to time, as the circumstances may require. 3. Periodical proportion of the interest paid in advance applicable to the current fiscal period under review.	1. Amount of interest on deposits. 2. Amount of interest on notes receivable. 3. Amount of balance should be transferred to profit and loss when books are closed, after which this account will be closed.

Note: Separate accounts may be kept for interest earned and interest expense.

Premium on Capital Stock

Debit:	*Credit:*
	1. Premium on sale of capital stock above par. 2. Balance of this account should be credited to a special surplus account, after which this account will be closed.

Returned Purchases

Debit:	*Credit:*
	1. Goods returned by us to creditors, debiting creditors' accounts therefor at same time. 2. Balance to be periodically transferred to Purchases account, after which this account will be closed. Purchases account will then reflect the net purchases for the period.

Purchase Rebates and Allowances

Debit:	*Credit:*
	1. Total amount as shown in rebate journal. 2. Balance to be periodically transferred to Purchases account, after which this account will be closed.

MISCELLANEOUS INCOME

Debit:	*Credit:*
1. All deductions from the income shown contra.	1. All items of income not otherwise taken up. 2. Balance of account to be transferred to Profit and Loss, after which this account will be closed.

PROFIT AND LOSS

Debit:	*Credit:*
1. Balance from Purchases account. 2. Debit balances from all expense accounts.	1. Balance from Sales account. 2. Credit balances from all income accounts.

NOTE: Balance of account, debit or credit, is transferred to Surplus account.

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